THE CONTRACTS OF INDIVIDUALS AND ORGANIZATIONS

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ABSTRACT

In this paper, we juxtapose the prominent role of contracts in economic and organizational theory with emerging research on the psychological contracts of individuals. This paper focuses on promissory contracts and the organizational and psychological factors impacting the contractual elements of promise, payment and acceptance. We describe a continuum of contracts and terms from transactional to relational, which helps explain the divergent descriptions of contracts made in sociological models of contracts, agency theory, and transaction cost economics. In reviewing these models, the contract framework explicates the premises under which each perspective operates, and raises questions regarding the assumptions of economic and organizational theory for individual responses to contracting. Taking a behavioral view of contracts, we then review empirical research on psychological and implied contracts and its links to psychoeconomic models and non-pecuniary models of individual behavior. Finally, we outline the implications of a contract framework for organizational research, including propositions for the creation, change, violation, and fulfillment of contracts by individuals and organizations.

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Our faith beforehand in an uncertified result is the only thing that makes the result come true.

—James (1897)

Contracts are fundamental to the behaviors of individuals and the actions of organizations. They imply cooperation and consensus, but often engender dispute and disagreement. They are used to characterize self-serving economic activities as well as sentient, communal relations. This paper addresses psychological contracts and their organization-level counterparts. Our central thesis is that contracts in organizations are fundamentally mixed-level phenomena: constructions created of individual cognitions and organizational context. Contracts can both create the contexts of work and be shaped by them. As interactions of person and context, contracts offer organizational scholars a link between micro and macro models of organization and work.

Contracts figure prominently in many economic and organizational theories. Theorists claim contracts substitute for markets (Williamson, 1979) and trust (Okun, 1981), create organizational forms (Stinchcombe, 1986a), and foster psychological attachment of members to organizations (Argyris, 1960; Levinson, 1962; Rousseau, 1989). Organizational scholars often infer the existence and operation of contracts in organizations but may not directly measure them (Alchian & Demsetz, 1972; Stinchcombe, 1986a; Schein, 1980), framing general propositions with little attention to the contract's composition, distinctive terms or intrapersonal constructions. Conventional wisdom regarding contracts is a bundle of contradictions (Table 1). In this paper,

Table 1. "The Nexus of Confusion" Conventional Wisdom on Contracts

Contracts create trust	Contracts create mistrust
Contracts are substitutes for trust	Contracts are a symptom of mistrust
Short-term contracts are more efficient than long-term contracts (agency theory)	Long-term contracts are more efficient than short-term ones (transaction cost economics)
Contracts are organizations in miniature (Stinchcombe)	Contracts are substitutes for organizations (Stinchcombe)
Internal labor markets are competitive advantage (1970's CW)	Internal labor markets are fat (1980's CW)
Contracts are substitutes for hierarchy	Contracts create hierarchy
Contracts are a symptom of a market failure	Contracts increase the efficiency of markets
Contracts are legally binding	Contracts are not worth the paper they are written on

Note: We acknowledge our debt to *Newsweek* for this format.

we use individual psychological processes to inform us about how people make, sustain, and fulfill contracts; and we use organization and market forces to understand contract functions and their context. Our aim is to advance research on contracts in organizations, particularly employment-related contracts.

This paper begins with an overview of contracts and their meanings and identifies two major contract forms: promissory and social. Focusing on promissory contracts as a fundamental linchpin between organizations and their members, we then describe the elements necessary to create a promissory contract. We then discuss the role of expectations, delayed repayment and reliance in contracting. Next, we address the *types* of terms these contracts have, using the distinction between transactions and relationships to characterize conditions found in promissory contracts. Within the framework of promissory contracts outlined here, we then review the major organizationally relevant literatures employing contract or contract-like constructs in modelling organizational processes and individual behavior. We propose a framework characterizing the dynamic nature of contracts in organizations from creation, through change, to fulfillment. In this framework, we suggest propositions and directions for future research.

CONTRACTS AND THEIR FORMS

The most general description of a contract is the belief in obligations existing between two or more parties. In Webster (1986), contract is defined as an agreement between two or more people to do something and *Black's Law Dictionary* (1983) says it is an agreement which creates an obligation to do or not to do a particular thing. Obligation is a commitment to some future action and agreement means mutual acceptance, but what the commitment means exactly, when its fulfillment is anticipated, and the extent of mutuality itself opens the contract to contention. Agreement exists in the eye of the beholder and not necessarily in fact.

The act of "owing" commits a person to some future payment or action. Seniority can reflect an organization's obligation to continue employment if it is able and to sustain the employee's standard of living if it cannot. The senior employee may be bound to develop specific skills useful to the employer and eschew support for competitors. Commitments on both sides may be based on communications, customs and past practices. These obligations arise from one of two forms of contract: social or promissory. *Social contracts* are normative, addressing shared, collective beliefs regarding appropriate behavior in a social unit (often discussed at the level of the organization or society by anthropologists and philosophers; see Gough, 1963; Homans, 1961). Norms of exchange, reciprocity, and prosocial behavior can create obligations between work groups or within organizations. Such social contracts are in effect cultural.

Promissory contracts are essentially paid-for promises where commitment of future behavior is offered in exchange for payment. Often viewed as a form of economic exchange, promissory contracts in fact cover a broad array of exchanges from spot markets (one-time exchanges) and temporary employment to marriages and academic tenure. Goods, services and money may be exchanged in the form of either promise or payment along with a host of nonmonetizable factors such as loyalty and fidelity. Whereas social contracts are largely inherited at birth or acquired by membership, promissory contracts are voluntarily entered. While one pervades a social unit, the other can be actor-specific.

However, promissory contracts do not occur in a vacuum but in a social context. Norms of social contract do impact the nature and, perhaps more importantly, the interpretation of promises. The importance of social contract as an interpretive backdrop for promise is consistent with Atiyah's (1981) argument that legal contracts vary from country to country by virtue of social norms regarding what constitutes a promise. In the Soviet Union, for instance, the notion of an implied contract or understanding has virtually no meaning. Unless the terms are in writing, they are not honored or binding (Rajan & Graham, 1991):

> All contracts between American firms and Soviets are generally governed by Soviet law, which does not recognize oral agreements.... Written contracts then supersede all previous unwritten agreements and implied assumptions...the Soviets insist on writing down...things taken for granted in Western nations such as verbal confirmations of receipt of goods and telephone reorders. (p. 45)

In the West, oral agreements have a long history (MacNeil, 1985), contrasting notions of trust, good faith, and fair dealing in two cultures. Thus, social context impacts the meaning of promise and its violation, the scope of obligations associated with promises, and the degree of mutuality parties share. Although social and promissory contracts are distinct, social contracts create the context and shape the terms of promissory ones.

Promissory contracts are created through social interactions and derive meaning from the societies in which they occur. In Sweden, a promise is a commitment obligating a person legally. In the United States a promise is typically not binding unless it is paid for, hence the definition of contract in U.S. (and all English-derived) common law. Lest the reader object to the appropriation of legal terminology to psychological or social realities, let us make clear our position: Promissory contracts are universal psychological and social phenomena. In the same way that expectancy theory presumes that all individuals seek to maximize personal outcomes whether their society be capitalistic, socialistic, tribal, or transitional, we hold that promissory contracts bind people to future courses of action to their mutual benefit. Just

as there is a pervasive social norm for reciprocity (Gouldner, 1960), so too is contracting a pervasive social norm. Contracts structure anticipated future exchanges, reducing uncertainty (e.g., defining roles, specifying future courses of action), creating social units (e.g., partnerships, organizations, joint ventures), and managing interdependence between individuals, groups, and organizations. Nonetheless, the form and elements of contracts, and even the language used in the contract, will vary due to socially defined meaning attached to promises, time perspectives, and relationships between the parties.

Intertwining promissory and social contracts creates a host of commitments and obligations often most apparent in their breach or when undergoing change. Consider this scenario: A vice president of a large appliance manufacturing company, who has given fully and generously of his talents for over 25 years, appears to have run out of steam. He rejects angrily any suggestion of early retirement, saying it is unfair to treat a loyal employee like a "pair of old sneakers." The president consults with the board of directors, who are divided over what to do. The firm has always prided itself on being a "people company," and many feel that treating senior employees with anything less than honor and dignity reflects poorly on the firm. Others feel that respect must be continually earned and that this vice president's presence is not only nonproductive but counterproductive. How this situation might be played out given an organization's history, ongoing organizational developments and changes, and particulars of the case (two years or ten before retirement) reflects the organization's values and culture, its leadership's goals, and larger societal context (e.g., laws, national culture).

The foundation of social contracts, social norms and culture, already receives substantial attention in organizational research (e.g., Frost et al., 1991; Schneider, 1990). In contrast, promissory contracts enjoy comparatively less scholarly attention outside of law and philosophy (e.g., Atiyah, 1981; Robins, 1984) despite their increasing relevance to the changing employment relationship (Hirsch, 1991; St. Antoine, 1985). Our focus in this paper is on promissory contracts as the relatively less explicated contract form in organizational research.

PROMISSORY CONTRACTS

> I was promised a dynamic and challenging environment...rubbing elbows with some of the brightest people in the business. A big lie. The true picture started to come out...after the initial hype...of working at one of the best 100 companies in the US had worn off."
> (MBA 2 years into first job)[1]

The Elements of Promissory Contract

As a paid-for-promise, promissory contracts have three components:

- *promise*–a commitment to do (or not do) something;
- *payment*–something of value offered in exchange for the promise, referred to in law as the consideration;
- acceptance—consent to the terms of the contract reflecting the contract's voluntariness.

Promise

Promises are the communication of a commitment to a future course of action. Such communications may be oral or in writing, behavioral or observed. The key element in communicating a promise in a contract is a behavioral event. Promise is not mere belief in the existence of a commitment: it is communication of a future intent. Statements in writing regarding duration of employment (whether time frames are specified or open-ended) and oral discussions in the recruiting process regarding future career opportunities are behavioral events which can convey promises. Yet words are not required to create promises. Organizational actions (e.g., requiring employees to serve probationary status before wearing the company uniform) can communicate commitments (e.g., that the change in status creates stronger ties between the person and the organization). Observation of treatment received by other employees (retention, offers of early retirement) can be construed as promissory in organizations where norms of internal consistency or equity exist. Social learning through observation of other organization members may be a powerful factor in communication of promises. The relevance of these others to an individual's relationship with an employer is a fundamental issue in the communication of promises through observation of the treatment that others receive. Would employees of IBM construe a promise from their employer by witnessing a friend's experience at Xerox? Unlikely. Referent others in contract creation are comparable parties to the same contract. Rousseau and Anton (1988, 1991) evoked the "reasonable third party" rule to determine whether communication of a commitment has occurred when promises are construed through observation rather than overt verbal expression, finding evidence that obligations arise without verbal expression.

Payment

Payment following a promise changes its meaning. If an aunt promises to leave her niece a valuable necklace in her will and does not, she breaks a promise but not necessarily a contract. However, had the aunt demanded the niece drive

her to church every Sunday as a condition of that promise, and then left the necklace to another, a contract is broken if the niece accepted and fulfilled her part. Failure to honor a promise may be considered bad faith or bad manners but in most cases is not construed as violating a contract. However disappointing broken promises might be, responses to violated contracts go beyond disappointment to anger and moral outrage (Rousseau, 1989) as well as litigation and redress (Kaufman & Stern, 1988).

Payment may be in the form of another promise, perhaps to work hard, be dependable, or to help a business prosper. It is prone to the same subjectivity as the promises made by the other party. Belief in a contract is enhanced when a promise precedes rather than follows an employee's contribution. As individuals make attributions about the underlying causes of their own behavior, the promise of a raise for hard work before the employee exerts the effort is more likely to be construed as a motivator or cause of that effort than is the promise of a raise given after the fact (Nisbett & Ross, 1980).

Acceptance

Voluntary participation is another element of contracting, reflecting each party's willingness to make commitments to the other. Acceptance is important, as it is the behavioral event that defines the contract and differentiates mere promise from contract. For example, the mere act of opening the cellophane around a software package indicates one's acceptance of the terms of the copyright agreement associated with the use of the software. In many cases, payment or fulfillment of contract terms implies acceptance (as in the case where an employer offers and an individual accepts a job), and even simple failure to exit may be construed as acceptance when alternatives exist. However, in organizations, after the hiring process is complete, attempts by either party to change or add to the contract need not necessarily be accepted. Employees of a firm acquired by another may find their previous contracts abrogated yet fail to accept or voluntarily enter into an agreement with their new employer. Gaining their acceptance may require soliciting commitment to participate in training, career development and other personnel actions characteristic of the new firm. The acquiring firm may ask employees to go through the recruiting process to signal the transition to membership in a new firm and a different contract. In some cases such participation may still feel coercive rather than volitional. Moreover, during downsizing where employees do more work than previously for the same or less return, acceptance cannot necessarily be inferred by their performance of organizational demands. If there are no available alternative forms of employment, their continued participation need not be voluntary. All three components, promise, payment, and acceptance must exist to create a contract.

ALL CONTRACTS ARE EXPECTATIONS, ALL EXPECTATIONS ARE NOT CONTRACTS

An issue in understanding contracts is the more general notion of expectation in theories of motivation and economic behavior (e.g., expectancy theory, social information processing, and subjective expected utility maximization). In fact, one function of a contract is to reduce uncertainty, which contracts may do by creating expectations about behaviors and outcomes. Expectations take many forms from beliefs in the probability of future events (effort to performance relationships and performance to outcome contingencies) to normative beliefs (prescriptions or beliefs regarding required or appropriate behaviors). One recent MBA alum reports:

> I expected to receive a promotion after my first year because my performance reviews were the highest (of my cohort). Although no one was promoted, I am upset. They should have managed my expectations.

Expectations such as this recruit's reflect probabilistic beliefs as well as contingencies, along the lines of expectancy theory. But they need not be contractual if promise is absent. In contrast, another recent alum recounted that:

> I was promised advancement after a year as a condition of taking this job and my good performance.

She may have a violated contract if she performs well and is not promoted.

Contracts are a distinct form of expectations and have in many ways farther reaching effects. Coupling promises and payments in the creation of expectations changes their meaning and impact. Why the difference? Contracts involve two elements that broaden their impact on the individual's behavior and responses: delayed repayment and reliance.

Delayed Repayment and Reliance

Delayed repayment provides a basis for a continuing ongoing exchange, often termed a "relationship." Conditioned upon a promise, delay in receipt of rewards or returns necessitates trust and a forecast of future behavior (e.g., Parks & Conlon, 1989; Parks, 1992). Delay also creates both an intervening history which may modify the relevance, interpretation, or contingencies associated with contract fulfillment, as well as the opportunity for maturation effects. Maturation, predictable change in the contract parties occurring with the passage of time (aging, acquiring new skills, valuing things differently), can increase the value of the exchange.

In a hunter-gatherer society, hunters may share part of their kill, typically the excess that cannot be consumed entirely by those involved in the hunt. The value of consuming the whole kill is less than the value of sharing the unneeded portion with others, provided the act is reciprocated at some future date. Repayment on the spot is both unlikely and not valuable (Lee & DeVore, 1968). Maturation in this case refers to the fact that the hunter who is no longer hungry today may be hungry tomorrow, or in need of shelter or other support from comrades. For the successful hunter to share the kill with others is valuable and yet not costly to the hunter because all the kill could not otherwise be eaten at once nor effectively stored.

Sharing over time creates the opportunity for future reciprocity, a benefit far more valuable to the hunter than eating the kill alone. Similarly, in organizations, rookies can be hired and paid a salary greater than their current contributions predicated upon the assumption that in future they will return the investment. Sacrifices for future gains are one form of delayed repayment, long-term planning for retirement, skill enhancement, or career development are others.

Reliance is derived from delayed repayment. Exchanges over time create relationships involving trust, predictability and often ongoing interactions. Frequent interactions introduce socioemotional concerns including the need to maintain and stabilize relationships through information exchange and concern for the long-term well-being of the other. Reliance on fulfillment of a paid-for-promise risks costs in foregoing other opportunities. It also raises concern over the ability and willingness of the other party to fulfill the bargain. The risk and trust involved can generate monitoring not only of each party's behavior but also of the strength of the relationship itself. Monitoring in intimate relationships has been categorized as "secret tests" (e.g., monitoring whether a spouse remembers an anniversary without being reminded, Baxter & Wilmot, 1984). Exchange relationships are also subject to monitoring to determine the relationship's strength and feasibility of continued reliance (e.g., feedback-seeking; Ashford & Cummings, 1983). Troubled relationships with high reliance are likely to generate high levels of monitoring.

Delayed repayment and reliance are key elements in models of reciprocity. Models of social exchange (Burns, 1973; Emerson, 1981; Homans, 1961; Mauss, 1954; Sahlins, 1972) suggest that giving creates an obligation for the receiver to reciprocate. The reciprocity act is different from tit for tat imitation types of interactions since there is no necessary similarity in what is exchanged (Argyle, 1969). Reciprocity involves equivalence in reward value, is not immediate and unthinking, but a carefully calculated act following after an appropriate interval of time. In studies of reciprocity in primitive societies, anthropologists distinguish between three degrees of reciprocity (Sahlins, 1965): generalized or altruistic where A gives to B without thought of rewards, balanced or economic reciprocity where A and B give exactly equivalent reward to one another, and negative reciprocity where each tries to get more than he or she gives. The type of relationship appears to impact the form reciprocity takes. Relatives or kin are likely to engage in altruistic or generalized reciprocity. Non-kin who are members of the same social group (e.g., tribe) demonstrate economic reciprocity consistent with their interdependence in the economic life of the community. Inter-group or intertribal relations are characterized by negative reciprocity.

Interestingly, Walster, Berscheid, and Walster (1973) make a case for people's preferences to receive benefits which they are able to repay, citing cross-cultural research including Gergen, Diebald and Siegel's study (cited in Walster et al., 1973) in which beneficiaries unable to repay a donor evaluated the donor less positively than did those able to reciprocate. Consistent with Homans's (1961) matching hypothesis, it seems the more equitable a relationship the more viable it will be.

Promissory contracts signal the extensive role of mutual binding obligations that construct organizations and make actors able to predict and rely upon one another. MacNeil (1985) notes that a fundamental error in much of our thinking about contracts is the image of a discrete, promissory contract negotiated and executed in a vacuum free of relational or social concerns. Models of social exchange indicate that continuing exchanges make individual transactions contingent rather than independent (Homans, 1961; Sahlins, 1972). According to MacNeil, certainly agreements can occur when there is nothing else between the parties, never has been, and never will be, but agreements executed over time come to be characterized by "(t)he entangling strings of friendship, reputation, interdependence, morality, and altruistic desires" (MacNeil, 1974, p. 595).

FROM TRANSACTIONS TO RELATIONSHIPS: THE CONTRACTUAL CONTINUUM

Promissory contracts are fabrics of many textures and hues, patterned to reflect a variety of underlying exchanges and interdependencies. MacNeil (1985) proposed a continuum of contracts (interpreted here in Table 2) reflecting varying degrees of specificity, scope, and flexibility. Anchoring one end of the continuum is the transactional contract comprised of short-term monetizable agreements with limited involvement of each party in the lives and activities of the other. Temporary employment, commission sales, and independent contracting are all examples of transactional contracts. At the other end of the continuum, relational contracts characterize agreements based upon exchanges of both socioemotional (loyalty, support) and monetizable elements (pay for services), duration which is open-ended and often long term, and a high degree of flexibility.

Table 2. From the Transactional to the Relational Characteristics of the Contractual Continuum

Contract Characteristics	*Transactional Contracts*	*Relational Contracts*
Focus	Economic Extrinsic	Economic Socio-emotional Intrinsic
Time Frame	Close-ended Specific duration	Open-ended Indefinite duration
Stability	Static	Dynamic
Scope	Narrow	Pervasive and comprehensive
Tangibility	Public Easily observable	Subjective Understood

Source: Adapted from Rousseau (1990) and MacNeil (1985).

Transactional agreements have a high degree of specificity albeit a narrow focus. With relatively brief time frames (often day by day), both parties maintain substantial flexibility to negotiate new contracts with different terms and even new partners. Brief time frames and a narrow focus create exchange relationships whose parties have limited involvement in the relationship in terms of dedicated assets, organization-specific skills as well as emotional ties and loyalties. An advantage of this partial inclusion is the availability of transactional contracts for termination or substantial modification with relatively little emotional impact on affected parties. Transactional contracts exemplify pooled interdependence (Thompson, 1967) with parties contributing independently. As Thompson suggested, parties to pooled interdependency are coordinated through rules, paralleling the specificity of the transactional contract. Contract terms are congruent with the nature of the relationship and interdependencies between the parties. Highly specified, rule bound contracts suit temporary employment and other distant relationships but may be incongruent with "close" relationships (Parks & Conlon, 1991), such as those involving long-tenured veterans.

Transactional contracts can serve as a trial run before formulation of a longer term relational agreement (e.g., probationary employment) and can evolve into relationships as in the case of organizational consultants and other independent contractors with whom organizations become interdependent. In such instances, transactional contracts are a risk-minimizing strategy for identifying appropriate partners for longer-term arrangements. Note that in transactional contracts uncertainty is handled outside the context of the contract (e.g., through availability of alternative partners).

Relational contracts are reciprocal obligations whose terms are typically general (excellent training, good long-term career possibilities) and subject to clarification, modification, or further articulation as circumstances evolve and interactions between parties continue. MacNeil (1985) characterizes relational contracts as open-ended, containing monetizable and socioemotional elements, broad in scope, and often highly subjective, governed by values of good faith and fair dealing and the motivation to sustain the relationship over time. Such contracts characterize a wide variety of personal relationships of which marriage is the best example ("Through sickness and in health" is a well-stated avowal that the contract is intended to survive uncertainty). High seniority employees, government defense contractors, and even non-tenure track university lecturers employed beyond some initial probationary period (see Smith, 1990, p. 119, for a discussion of "moral tenure" in academia) all may be parties to relational contracts. Their evolutionary nature and reliance on mutual adjustment and modification characterizes relational contracts as forms of reciprocal interdependence in Thompson's (1967) framework. Management and coordination of work involving parties to relational contracts entails extensive flexibility and feedback.

This contractual continuum appears to have a psychological reality. Rousseau (1990) found that two factors characterized patterns of employee and employer obligations reported by new recruits, a transactional one emphasizes fast track advancement and pay for performance and a relational one including loyalty and longer-term commitments. Evidence also suggests that as contracts become less relational employees perceive their employment arrangements to be more transactional in nature (Robinson, Kraatz, & Rousseau, 1991), suggesting not only that different contract types exist but also that a movement exists between them.

CONTRACTS IN MACRO AND MICRO ORGANIZATIONAL THEORY

Promissory contracts are entangled strings of sentient relationships and interdependencies, widely evident in organizational and economic theory. Research streams relevant to contracts in organizational settings have typically focused on one level (either organizational or individual) in isolation from the other. In this section, we will explore several intact paradigms which separately and together can both inform and be informed by promissory contracts.

Organization and Market Level Models of Contracting

At the level of the organization and its markets, sociologists and economists have modelled distinct forms of contracting.

Sociological Models of Organizational Contracts

Sociologists typically treat contracts as organization-creating. Stinchcombe (1986b, p. 267) suggests that "every contract is an organization in miniature, a normatively controlled exchange relation... and every organization is a system of contracts." Contracts structure member behavior by specifying decision-making authority, information flow, incentives and performance standards. Linked to a broader theory of social exchange (Blau, 1964; Homans, 1961), sociological treatments of contract emphasize that exchange creates status and power differences, one dimension of which is the organizational hierarchy. Asymmetries in power reinforce asymmetries in exchange, where power is a function of the reliance or dependency of one of the parties on the other. Power, then, is an attribute of the *relationship*, rather than being vested in individual exchange partners (Emerson, 1962). Dependence of some contract parties on others can impact both contract terms and the contract's degree of voluntariness, when one party cannot exist outside the relationship as easily as the other. Dependence is related to availability of alternative partners suggesting that contract terms and their acceptance may vary in meaning from one network of relationships (firm, industry, society) to another. A social exchange perspective on contracts suggests:

1. Contracts create organizational hierarchies and roles.
2. Contracts give rise to power asymmetries.
3. Contracts are influenced by differences in power, creating unequal bargaining positions.
4. Each contract is part of a larger set of exchange relationships.

Agency Theory

Economic theories employing the concept of contract are predicated upon the assumption that certain contracting arrangements foster profit maximization, conditioned upon uncertainty and satisficing (Perrow, 1986). Contracts are central to both agency theory and transaction cost economics, each perspective also assuming that individuals act out of their own competitive interests. Designed to identify conditions for profit maximization under individual competitive self-interest, each theory forecasts distinct advantages for specific contract forms.

Agency theory addresses the problem of shirking, where one person delegating a task to another cannot trust that person to give honest reports of effort (Alchian & Demsetz, 1972; Fama, 1980; Jensen & Meckling, 1976). Agency theory focuses on the relationship between two entities, where one party (the principal) gives another party (the agent) authority to act on his or her behalf (Fox, 1984). The relationship between principals and agents is governed by a contract specifying what agents should do and how principals will compensate them for their actions.

From a contracts perspective, agency theory is predicated upon a bilateral contract. However, the theory's focus on violation is virtually entirely on the *agent's* failure rather than that of the principal. Agents may shirk or misrepresent their capabilities but principals are generally not considered to cheat or misrepresent. The language of agency theory is reductionistic, treating organizations and their owners on the one hand and agents or employees on the other as individual actors (Levinthal, 1988).

Agency theory assumes individuals are rational beings maximizing a single utility (i.e., the trade off between money and leisure) rather than sentient ones with personal ties to others. Principal-agent contracts are volitional in that agents are able to exit without costs and contract with other principals (employers) if their self-interests are not fulfilled by the arrangement. Principals are free to find other agents if either the demands of labor or losses from shirking are too high.

Adverse selection and moral hazard are concepts employed in agency theory to flesh out the role of context in the principal-agent contract. Specifically, adverse selection and moral hazard occur because of information asymmetries between the principal and the agent, and because the agent is assumed to always act in his or her self interest (opportunism). Adverse selection refers to the contracting of agents unqualified to fulfill their end of the bargain due to active misrepresentation of the agent's competence and expertise. In this case, adverse selection occurs due to information asymmetries between the principal and the agent concerning the agent's competence, and consequently restricts the principal's ability to hire suitable employees. The moral hazard problem of agency theory refers to the agent's lack of effort (Eisenhardt, 1989), and follows the selection of the agent. Moral hazard occurs due to information asymmetries concerning the agent's efforts, where the agent shirks and reduces his or her efforts when the principal is not able to actively verify or observe the actions of the agent. Adverse selection and moral hazard then create the need for such organizational control mechanisms as performance reviews and merit-based pay to reduce shirking, and specialization of labor to suit the average person's skills given the inability to select the most competent (Perrow, 1986).

Agency theory predicts that short-term contracts are more efficient than long-term ones since spot markets permit regular renegotiation of contracts in response to environmental changes (Perrow, 1986). However, Holmstrom (1979) suggests that when the agency relationship repeats itself over time, uncertainty is reduced and dysfunctional behavior is more accurately revealed, alleviating the problem of moral hazard. In other words, repeated transactions facilitate the creation of trust (Axelrod, 1984). The creation of trust in the agency relationship may then reduce the inefficiencies associated with long-term contracts (Barney, 1990; Zucker, 1986).

The focus of agency contracting is asymmetrical. Adverse selection or shirking by principals is not addressed. That a company might claim financial health during recruitment only to close its doors after the recruit hires on is a variation of adverse selection typically not considered by agency theorists. Shirking by employers is also ignored; thus agency theory does not consider that a firm might downsize its workforce and demand employee concessions during a recession, despite having the financial capability to sustain itself without such cuts.

To control for agent opportunism, agency theorists postulate the use of contingent contracts when it is not possible for principals to observe or otherwise monitor the agents (e.g., Eisenhardt, 1989). The use of contracting as a control mechanism has expanded (e.g., Argawal & Mandelker, 1987; Jensen & Meckling, 1976; Kosnik, 1987). Opportunism is reduced by increased likelihood of detection (e.g., monitoring), increased magnitudes of penalties, and inducements in the form of wages above industry averages (Leatherwood & Spector, 1991). The well-known monitoring effect in agency theory has received empirical support (e.g., Conlon & Parks, 1990; Eisenhardt, 1985, 1988; Parks & Conlon, 1992), however, only to a limited extent. Support for agency theory is conditioned on both social factors (e.g., traditional forms of compensation; Conlon & Parks, 1990; Eisenhardt, 1988) and environmental conditions (e.g., scarcity/munificence; Parks & Conlon, 1992).

Although the agency perspective generally presumes shirking will occur and focuses on mechanisms to reduce it, other researchers find a reluctance on the part of agents to breach a contract. Shanteau and Harrison (1991) observed in a series of experiments the persistence of employee commitment to an *ex ante* contract, in spite of economic incentives to breach the contract. Subjects required extensive cuing by the researchers regarding the economic value of breaching their contract before a plurality of subjects was willing to do so. In spite of the experimental manipulations, salient economic incentives were still insufficient to persuade a large proportion of the subjects (38%) to breach their contract. Not only may agency theory overestimate agent willingness to breach a contract, but Castanias and Helfat (1991) argue that there may be oversufficient justification for agents (including managers) to generate profits for the firm due to relational, intrinsic, and ego-gratifying rewards linked to good performance. Specifically, Castanias and Helfat (1991) argue that when only economic incentives are considered, then the self-interested behavior assumed by agency theory may indeed be manifest. However, when motivational factors other than self-interest are considered, such as the need for achievement or the need for affiliation, agents may behave in an "other" interested, rather than purely self-interested manner (Parks & Conlon, 1992; Seabright, Levinthal, & Fichman, 1992). Agency theory and its prescriptions rely on external forms of control, such as the contingent contract or the monitoring of agent behavior, yet internal forms of control may also govern agent behavior (Parks & Conlon, 1992). As noted by Cummings and Anton (1990), individuals often hold themselves accountable, even in the absence of external control mechanisms such as those suggested by agency theory.

Admission of asymmetries in power or willingness to shirk would necessitate acknowledgement of an authority or hierarchical relationship between principals and agents—an implication threatening to the centrality of the principal-agent contract that agency theory promulgates. For many proponents (e.g., Jensen & Meckling, 1976) the firm does not exist—everyone is a free agent. Yet, as noted by Arrington and Francis (1989), the language of agency theory itself creates entitlements and privilege for the principal, in spite of the classic assumptions that both parties are exercising free choice. The tendency of agency research to focus on single period models and to focus on loss rather than gains from longer time perspectives suggests that transactional constructions of contracts permeate this perspective.

Summary. From a contracts perspective, agency theory suggests the following:

1. All individual agents (e.g., employees) are party to the same contract unless a differential role is specified and these individuals will accept that contract.
2. Shirking is a major problem in contracting.
3. Individuals are more prone to shirking than to the fulfillment of contracts.
4. Individuals are more prone to shirking than are organizations.
5. Individuals actively misrepresent their competence.
6. When contracts are violated, both the individual and the organization are equally able to exit the relationship

Transaction Cost Economics (TCE)

Wrestling to find an explanation for the twentieth century change in organizations from many small ones (a market) to a few large ones (hierarchy), Williamson (1975, 1979, 1985) created a model in which efficiency at the level of the organization could be attained through transactions. In the TCE framework, the reasons why large organizations are efficient derive from the four basic components of TCE's perspective: uncertainty, small numbers bargaining, bounded rationality, and opportunism. Uncertainty or market instability refers to changes in the environment owners cannot foresee or control. Small-numbers bargaining derives from the creation of long-term contracts with a few suppliers, employees or customers. If a firm enters into a long-term contract, it upsets the normal market. Parties now have both experience and resources that give them an edge over their competitors. The emergence of asset specificity which other job seekers or competitors lack

creates leverage which the current employees, customers, and suppliers may use against the firm. Since there is always limited information and contracting parties have bounded rationality, they cannot know whether each represents itself honestly to the other. Here is the classic situation demonstrating the rule that "no problem's solution fails to generate another problem." The resulting opportunism (i.e., exploitation of one's position to the disadvantage of the other) creates further behavioral uncertainty hampering efficiency (e.g., profitability). Opportunism, lack of competitiveness in bargaining, and limited information coupled with environmental uncertainty create transaction costs.

The exercise of opportunism resulting from asset specificity and bounded rationality is reduced by the creation of hierarchies that substitute for the contracts described in agency theory. Hierarchies enhance monitoring capabilities. Moreover, the resultant social ties created by the longer-term contract may cause a reduction in opportunism (Granovetter, 1985), which may engender trust. These entangling social ties may promote the sharing of noneconomic information or the assumption of voluntary responsibilities creating signals (e.g., credible signals; Barney & Basinger, 1991) which enhance trust (Barney, 1990). Trust in exchange relationships is posited to reduce transaction costs associated with monitoring and to increase the efficiency of the exchange (Zucker, 1986). However, rather thán simply replacing agency theory contracts with hierarchies, TCE offers an explanation of how organizations facing uncertainty, bounded rationality and apprehension regarding opportunism can prudently enter long-term, often open-ended contracts. The specific terms of these long term contracts are difficult to create a priori because technological complexity and other uncertainty makes all necessary terms unknowable ex ante. How else to explain the five-year contract (not counting 'no cost extensions' and overruns) for a complex weapon system by the U.S. military based on technology not fully operational at year one? Long-term contracts are predicated upon relationships permitting unanticipated adjustments and accommodations. While agency theory predicts that short-term contracts will be more efficient, TCE maintains the efficiency of long-term contracts.

There is an inherent equilibrium in the contracts modelled by TCE. Asset specificity creates both an advantage favoring employees (the training companies have invested in them) that organizations lose with attrition and one favoring employers (firm-specific skills that may not be marketable elsewhere) that fosters retention. Williamson (1975, 1979, 1981) argues that very specialized investments (such as training) will strengthen the attachment or commitment of the parties to each other. This mutual interdependence creates a basis for a relationship that re-introduces the notion of contract into hierarchies.

TCE may seek to minimize transaction costs yet in effect what it describes is the transformation of transactions into relationships and the emergence of a new set of economic forces and social mores. The economic force is to reduce the costs associated with transactions, and to increase the efficiency of exchange. These cost reductions may be achieved through mechanisms such as incentive structures and elaborate monitoring systems. However, these cost reductions may also be achieved by relying on social and normative structures. For example, as noted by Barney (1990), there are some types of exchanges in which exchange partners can realistically assume that parties will *not* behave opportunistically, where social constraints militate against violations of trust. We argue that agency theory accounts for one form of contract in organizations: the transactional contract. TCE reflects development of longer-term contracts from former transactions due to the passage of time and repeated interactions. Transaction cost economics suggests that time, number of potential exchange partners, interaction frequency, technological complexity, and monitoring costs drive the creation, violation, and change of contracts. Contextual factors such as interdependence (small numbers), past practices, technology-based uncertainty as opposed to environmental (political or resource-based) determine whether contracts take transactional or relational forms.

Summary. From a contracts perspective, TCE suggests:

1. All employees performing the same job or role are party to the same contract.
2. Relational contracts are likely where there is environmental turbulence, a few possible contract partners, limited information, and competitive advantages that could be lost by attrition (technology or client transfers to competitors). Under these conditions, relational contracts are expected to be more efficient than transactional ones.
3. Membership in organizations involves sharing of information (economic and non-economic) and potentially enhances trust.
4. Trust can serve as a substitute for elaborate monitoring and governance mechanisms in controlling transactions.
5. Technological complexity fosters contract terms that are general a priori, made more specific with experience and later developments.

CONTRACTING IN PSYCHOLOGICAL MODELS: THE EYE OF THE BEHOLDER

Psychological Contracts: The Insider's View Point

Simon (1991) argues that despite economic assumptions that self-serving behavior is more adaptive than communal or altruistic behavior, much of individual behavior in organizations and broader social contexts is better

explained by a complex of loyalties, commitments, and interdependence that are not readily reducible to individual utilities:

> Why not assume that maximizing the firm's profit is precisely what maximizes the utilities of executives and other workers? In a society of robots, an owner would not settle for less. But most of us would think this an unrealistic assumption to make for a human society. An organization theory with an unspecified utility function is not a theory at all.... instead we should begin with empirically valid postulates about what motivates real people in real organizations. (p. 30)

Research into the psychological nature of contracts responds to the need Simon describes by empirically investigating individual constructions of contracts. Despite common agreement that promise, payment, and acceptance have occurred, parties to a promissory contract can have very different perceptions regarding its terms. Note also that our review of sociological and economic treatments of contract raises questions regarding the assumption that individual parties sharing the same role (e.g., employees, owners) enact the contract similarly. Recognizing individual differences in cognitions, values, and information processing, psychological models address various forms of what might be termed "contractual thinking."

The term *psychological contract* refers to an individual's beliefs regarding terms and conditions of a reciprocal exchange agreement between that person and another party (Rousseau, 1989). Originally employed by Argyris (1960) and Levinson (1962) to characterize the subjective nature of the employment relationship, the present use of the term focuses upon an individual's belief in and interpretation of a promissory contract. As MacNeil (1985) has argued, all contracts, whether written or unwritten are fundamentally psychological, existing in the eye of the beholder. Psychological contracts exist at the individual level where the beholder is party to the contract. Such contracts are characterized by perceptions, interpretation and sense making, and, in their violation, by strong emotions.

The inherent subjectivity of contracts stems from the fragmentation of contract terms, individual cognitive limits, and inherently distinct frames of reference (Farnsworth, 1982). Fragmented promises occur when promises are constructed out of distinct behavioral events or episodes communicating commitments. In a recent study, nearly 60% of a graduating MBA cohort reported contract violation in the first two years of employment (Robinson, & Rousseau, 1991; Rousseau, Robinson, & Kraatz, 1992). Their descriptions of the violated contract terms were highly subjective (e.g., "excellent training," "fast track advancement") suggesting that subjectivity, fragmentation of terms, and different frames of reference were a factor in violation. Similarly, Herriot, Pemberton, and Pinder (1992) report widely differing perspectives regarding the career paths perceived by senior managers for their line manager subordinates and those line managers for themselves. Herriot et al. suggest that mutuality is often lacking in contract terms and that prolonged interaction may be necessary for convergence in psychological contracts. Subjectivity can extend to include socioemotional factors such as affection and loyalty (as when organizations such as Federal Express describe employment in familial terms). Socioemotional elements of contracts may be more prone to variable interpretations than monetizable ones.

When promotion is promised for "satisfactory performance," those factors constituting promotion or good performance may not be discussed in detail. Fulfillment of the promise may depend not only on the employee's performance but also upon the extent to which the employee and employer agree upon what's a promotion and what's satisfactory performance. In this regard, research on two sides of the "joining up process" may reflect the management of the psychological contract: feedback seeking by the employee (often in the form of monitoring rather than direct inquiry; Ashford, 1986; Ashford & Cummings, 1983; Morrison, 1991,1992), and the realistic job preview provided by the employer (Wanous, 1980). Interestingly, Morrison (1991) reports that the type of information newcomers seek to fulfill their own role differs from that enhancing their acculturation—suggesting that promissory and social contracts may be fulfilled in divergent ways and are perceived as distinct. Specifically, Parks and Schmedemann (1992) found that there is a perceived gap between contractual (promissory contracts) and moral obligations (social contracts), and that moral obligations are created by promise-making language, with or without the creation of contractual obligation. For example, the inclusion of a disclaimer obviated perceptions of promissory obligation, but *not* social obligation.

Ambiguity exists not only in contract terms but also regarding exactly *who* are the contract's parties. A recruiter interviewing a newly minted MBA may promise a job assignment with a specific location, tenure, and staff support. Or, a product manager may offer that MBA future training opportunities. The recruiter's promises must be fulfilled not by the recruiter but by the rookie's product manager/boss. Who is bound by the promise the rookie paid for by signing on: the recruiter, the boss or "the organization?" Problems arise in contracting when a boss leaves: As one recent MBA indicates "Change in personnel is everything. My two mentors left to go to other divisions. Without them, my treatment is less special," and perhaps the MBA's deal is too. Fragmentation and ambiguity can stem from the fact that organizations have many agents or contract makers who make and receive commitments and those agents need not send or intend the same message.

Impact of multiple contract makers, conveying highly subjective terms, is demonstrated in research contrasting the violation rates of transactional and relational contracts (Robinson & Rousseau, 1991). Far more people characterizing their contract as relational reported violations. The psychological contracts of individuals who believe themselves party to the same

contract need not be mutual. This is due to nonmutuality in communication, multiple behavioral episodes and several agents conveying promises, as well as the limited number of issues addressable at the time a relationship is established. It is not mutuality that creates a psychological contract, but the *belief* in mutuality.

Summary. Research on psychological contracts suggests:

1. Contracts are idiosyncratically perceived and understood by individuals.
2. Subjectivity in the contract leads to disagreement between parties regarding terms and their meaning.
3. Feedback seeking will reduce uncertainty about the terms of the contract,
4. Realistic job previews will reduce discrepancies in the employee and employer understanding of the contract.
5. Transactional or more specific contracts are less subject to violation than relational, more subjective contracts.

Implied Contracts: What Witnesses and Third Parties See

Since the events creating the contract (promise, payment, and acceptance) involve several parties, contracts also exist at a supra-individual (e.g., unit) level. The unit-level or implied contract (Rousseau, 1989) operates at the level of the relationship (dyads such as manager-employee, organization-members, firm-firm as in the case of joint ventures). Unit-level contracts are implied because they emerge from social processes surrounding the interpretation of the set of events comprising promise, acceptance and payment.

In the context of a promissory contract, behavioral events conjointly creating the individual psychological contract also can be communicated publicly (observation, documentation, reports) and can be observed and interpreted by others. (Note that various terms have been used to describe this form of contract including "implicit contract" by Weick [1979] and "implied contract" by Rousseau [1989].)

Two forms of unit-level contract exist:

1. *implied contracts:* interpretations third parties make regarding the obligations existing between contract parties,
2. *normative contracts:* psychological contracts shared by members of a social unit.

Implied contracts derive from observation, communication, and social processes shaping judgements by outsiders to the contract. Normative contracts derive from convergence among individual beliefs in their own contract terms, likely a result of interactions over time subjecting these beliefs to social information processing (Salancik & Pfeffer, 1978).

Implied contracts are often articulated by jurists. Since they are observable and verified by others outside the relationship, implied contracts permit governance through reputational and legalistic forces. They also create traditions and policies that may constrain subsequent contracts (Conlon & Parks, 1990; Eisenhardt, 1989).

In a series of policy capturing studies, Rousseau and Anton (1988; 1991) and Rousseau and Aquino (1992) observed that third parties agreed on factors creating contractual obligations to retain employees (including formal commitments—promises, and performance levels—payments). In a similar policy capturing study examining obligations to follow promised procedures, Parks and Schmedemann (1992) observed a high degree of consensus between third party observers concerning the factors in the *language* which convey contractual and moral obligations (Parks & Schmedemann, 1992). Evoking the standard employed by Bok (1978) in determining the ethicality of decisions and behavior, Rousseau and her colleagues found that "reasonable third parties" concur on factors creating and sustaining employment contracts (Rousseau & Anton, 1988,1991; Rousseau & Aquino, 1992). Plausibly, third parties may be more veridical interpreters of contracts than either contract party whose views may be more bounded and fragmented. Reduced self-serving biases at the very least may make third parties "more reasonable" interpreters of the contract.

Contract-like concepts employed in economics and sociology typically conform to the notion of an implied contract, interpreting paid-for-promises from an outsider's perspective. Attributions made by nonmembers to stable and recurrent patterns of exchange are reflected in the notion of an internal labor market which assumes long-term reciprocal commitments, careers within companies, attractive and equitable wages and job security (Hirsch, 1991). Such attributions can include normative beliefs regarding job property, where job holders can come to believe in a strong sense of entitlement (Shahid, 1991) and ownership in their jobs (Pierce et al., 1991).

Normative contracts have received little attention in organizational research, which has only recently examined individual psychological contracts. Nicholson and Johns (1985) have argued that shared beliefs regarding the role of absences in one's contract can create a culture supporting absenteeism. But more research is needed on the degree of within-unit consensus on contracting and its impact on contract fulfillment, change, and violation. However, a social information perspective suggests that shared beliefs regarding past practices could be a powerful determinant of future contract terms (Salancik & Pfeffer, 1978).

Traditions arising from previous contractual arrangements, even when between different parties, form an anchor for subsequent negotiations (Conlon & Parks, 1990; Eisenhardt, 1988). Conlon and Parks (1990) found that the anchoring effect of the previous contract grow stronger over time, even when there were economic reasons for changing the terms of the contract. The truism "Past is prologue" may be particularly endemic to contractual arrangements where traditions and past practices provide a benchmark for establishing fairness in exchanges. Benchmarks can be used by both contract participants and third parties.

An individual's relationship to a given contract can at once be both as principal and third party, especially when there are several people in the same role. Research on the impact of layoffs on survivors (Brockner, 1988; Brockner et al., 1987) reveals that observers perceiving unfair treatment of others by their employer reduce *their own* efforts and commitment to the organization. Extrapolating to contract violation, such research suggests that organizational actions breaching the contract of one's coworkers undermine the relationship upon which one's own contract is based as well an individual's willingness to rely upon that contract to structure future interactions with the organization. Vicarious learning and modeling may be one mechanism through which such observations of others may impact beliefs in our own contract (Bandura, 1974; Wood & Bandura, 1989). This may occur when referent others (e.g., fellow employees) are believed to be party to the same contract. In addition, "similar-to-me" effects may operate such that when individuals so identify with intimates and coworkers (Clark & Reis, 1988) the treatment that another receives transfers to the self as well. In such cases, the individual appears to react as an insider rather than a third party to the contract.

Summary. Implied contracts research suggests:

1. Third parties tend to agree on key features of implied contracts, in contrast to the frequent lack of agreement between individual psychological contracts.
2. Reputation, corporate image, policies and procedures form a basis for contracts interpreted by third parties.
3. Implied contracts provide a basis for reputational and legal governance of the employment relationship.
4. Social norms exist regarding appropriate behavior by contract parties,
5. Individual parties to multi-party contracts may react as if their own were violated when they witness another's experience of violation.

Psychoeconomic Models

Individual proclivities for self-focused maximizing are explored by organizational psychologists empirically testing individually-focused utility models. Two such theories, expectancy and equity, are considered here with respect to their links with contracting.

Expectancy Theory

Expectancy theory as put forth by Vroom (1964) and Mitchell (1974) among others assumes that outcomes directly and immediately following from performance are more important to motivation than delayed ones. The basic notion is that people choose effort levels they believe will most likely lead to valued outcomes. According to the theory, three elements influence an individual's motivation: probabilities that effort will produce performance (expectancies), the covariation between performance and other outcomes such as pay (instrumentalities), and the subjective evaluations made of these outcomes (valences; Ilgen & Klein, 1988). Interestingly, tests of various forms of this model provide more support for it in organizational or occupational choice than in predicting effort or performance (Wanous, Keon, & Latack, 1983). To date this finding typically is attributed to methodological difficulties in operationalizing effort, performance, and their relationships. However, failure to specify other relevant variables such as perceived obligations or commitments may be a factor in expectancy theory's difficulty in predicting effort and performance. Attachment, loyalty, or psychological ownership are postulated to account for people's willingness to engage in extra-role behavior for which there are no direct rewards (Organ, 1990; Pierce, Ruben & Morgan, 1991), but operationalizations of expectancy theory have yet to succeed in reducing the associated psychological processes to an expectancy framework.

Summary. From a contracts perspective:

1. Expectancy theory has yet to address how delayed repayment effects valence and instrumentality. Ceteris paribus, in the expectancy framework, immediate repayment has a greater impact on member behavior than delayed repayment.
2. The role of obligations and commitments and extra-role behavior is not well understood from an expectancy framework when not reducible to monetizable terms.

Equity or Balance Theories

Equity theory addresses the comparison processes employed to gauge whether the resultant ratio is equitable or fair, and is modeled as cognitive processes by which individuals assess the fairness of the outcomes they receive relative to their contributions or inputs (O/I). Social comparisons in the form of referent others (Adams, 1965; Walster, Berscheid, & Walster, 1973) or personal frames of reference (Goodman, 1974) are offered as the basis for anchoring judgements of equity. Equity theory formulations imply people are capable and willing to perceive fairness in their immediate environment and process environmental and social cues in active pursuit of equity or balance in their exchange relationships (functioning as "intuitive accountants"; Bies, 1987), adjusting their behavior accordingly.

Landy and Becker (1987) argue that these may be unwarranted assumptions. For some levels of cognitive ability, fairness may be difficult to calculate, considering the metrics and variables of input and output. Hook and Cook (1979) argue that in all likelihood, rules for such transformations may be quite complex; hence the heuristic value of significant others (which Landy and Becker label a 'poor man's [sic] calculus'). Consistent with predictions of Piaget (1965) and Kohlberg (1976), Vecchio (1981) found that equity predictions are more accurate for morally mature individuals, people capable of weighing moral issues in a cognitively complex way. Thus behaving in a normatively moral way is a cognitive challenge, not a social one (Landy & Becker, 1987).

The role of cognitive limits in equity judgments is compounded in contractual thinking where information processing demands vary by contract type. Transactional contracts with more definitive terms and metrics facilitate the calculus while relational contracts tax the calculator who must solve for several unknowns whose values vary with time and experience. Moreover, as MacNeil (1985) points out, parties to relational contracts often eschew expressing its terms in monetizable ways because to suggest that the relationship reduces to "simple" economics is to challenge the socioemotional basis of loyalty and commitment to the relationship (as when spouses debate whose contributions to the household are worth more or employers create a severance package for long-tenured employees).

Huseman, Hatfield, and Miles (1987) posit that certain types of people are inclined to be equity sensitive, processing social cues into balanced exchange ratios whereas others are predisposed to beneficence (giving more than they get) or exploitation (taking more than they give). Such predispositions could themselves influence the nature of the contracts individuals enter, with transactional contracts more amenable to the equity sensitive who need reassurance of the fairness of their deal and relational contracts to those inclined to want to build or exploit a long-term interdependence. In a study of newly recruited MBAs, Rousseau (1990) found correlations between the type of contracts recruits believed themselves to be party to and their careerist motives. Recruits low on careerism, valuing loyalty and job security, described their employment contract as relational. Those recruits seeking fast-track advancement and high rates of financial return were more likely to be party to transactional contracts.

Research on the concept of adjustment equity explores the frame of reference people use in gauging the outcomes they receive. Traditionally, equity research focuses on one-time exchanges and thus emphasizes fairness criteria realizable in the short term. In contrast research by Birnbaum (1983) and Mellers (1982) suggests that individuals see equity as a goal to work toward over time rather than one to accomplish in one large step or adjustment. Landy and Becker

(1987) conclude that a good deal of equity research has looked at too short a time frame and too restricted a set of outcomes and inputs. Thus individuals who view output as something amortized over time might have distinct perceptions of equity if not distinct views of their own contributions as well. Landy and Becker further suggest we need to consider alternative definitions of equity that more closely match the calculating heuristics of our subjects.

Summary. Equity theory raises several issues pertinent to contracting:

1. Time frames can vary over which people evaluate the fairness of exchanges.
2. Individual cognitive capabilities effect evaluation judgments and by implication the organization and complexity of the psychological contract.
3. Personal style (personality, moral reasoning and values) impacts how individuals appraise equity and, by implication, how they enact a psychological contract.

NONPECUNIARY MODELS OF BEHAVIOR

Whereas psychoeconomic models largely reduce contract-related phenomena to monetizable terms, some behavioral models focus more on sentient and socioemotional concerns.

Need Theory

As a content theory specifying *what* motivates people rather than a process theory of *how* people are motivated such as equity or expectancy models, need theory might seem an unlikely link with contracts. Yet the very content of need models (security, relatedness, and self-expression) captures much of the rich array of contract terms. Too, the psychodynamics of need development resemble transitions encountered in contractual arrangements. Alderfer (1972) reduced Maslow's (1954) five need hierarchy categories to three and in doing so suggested that needs are organized along an underlying continuum. Arrayed from concrete to abstract, Alderfer's Existence-Relatedness-Growth model characterized lower levels as focused, narrow, and specified while the higher levels reflect greater uncertainty and ambiguity. Postulating a mechanism for how needs change, Alderfer suggested that as higher needs are frustrated, people regress toward more concrete ones. In a longitudinal study of psychological contract change, Robinson, Kraatz, and Rousseau (1991) found that people party to relational contracts when they were hired were more likely to develop transactional contracts over time *if* their relational contract was violated. Breakdown of relational contracts appears associated with an increased emphasis on concrete monetizable exchanges in employment.

How people come to think about or enact their needs is the subject of much controversy (Salancik & Pfeffer, 1972). Since contracts involve a priori specification of conditions to be fulfilled in the future, personal conceptualization of contract terms may be influenced by some of the same cognitive constructions. In their review of need theory, Landy and Becker (1989) raised a number of concerns from a cognitive perspective: How many categories (i.e., concepts) do individuals really use to decompose their reward environment? How are these arranged on a concrete to abstract continuum? To what extent do definitions and numbers of categories change situationally or developmentally? Similar questions can be asked of contract constructions. Interestingly, in a study of first, second, third and fourth year engineering students, Landy and Becker (1989) report that only simple categories were used by the first year students (who didn't distinguish between pay and promotion opportunities). In contrast, fourth year students had more complex categorizations, perhaps due to information obtained as they got closer to graduation or prospective jobs. Categorization of stimulus elements may be influenced by experience (e.g., need satisfiers) or by maturational factors (e.g., aging) which change the salience of stimuli and their relevance to the individual's well-being (e.g., retirement benefits).

Summary. From a contracts perspective, need theory suggests:

1. Relational contracts may serve a broader array of human needs than transactional ones.
2. Transitions from relational to transactional contracts reflect contract failure or individual frustration of attempts to obtain more sentient or expressive goals.
3. Interpretation of contract terms may change due to developmental and situational factors, becoming more complex over time.

Citizenship

Extra role performance or performance beyond expectations is the basis for research on the topic of organizational citizenship. Organ (1990) argues that when effects of satisfaction and fairness are separated, the latter will explain more variance in citizenship behavior. Dittrich and Carrel (1979) found that employee perceptions of equity showed stronger relationships with absence and turnover than did measures of job satisfaction, the traditional predictor of these withdrawal behaviors. Work attendance beyond some level may be a form of citizenship. Both attendance and citizenship may reflect the condition of the employee-employer relationship, including contract fulfillment by each party.

In the effort to create a more complete theoretical specification of Organizational Citizenship Behavior (OCB), Organ (1990) framed the citizenship phenomenon in terms strikingly familiar from a contracts perspective:

> We postulate a tendency for people to presume at the outset...a social exchange relationship with the organization. This presumption continues until the weight of interpreted evidence indicates that such a relationship is not viable because of unfairness. Disconfirmation of fairness in social exchange...prompts a redefinition of the relationship as one of economic exchange. (p. 66)

Interpreting OCB from a contracts perspective, we construe Organ's argument to mean that people are predisposed to seek relational contracts with employees absent salient cues or avowals to the contrary. (How Huseman et al.'s [1987] notion of equity sensitives fits in is unclear.) Relational contracts with their broader array of terms and socioemotional frame of reference encourage employees to behave in ways that are not strictly mandated by their employer. Failure to act as a citizen is not punished or sanctioned since it exceeds some minimum role requirement, thus employees engage in citizenship voluntarily and at their discretion. Yet, employees experiencing unfair treatment by the employer withdraw this form of contribution. Moreover, Organ argues that not only does unfairness reduce citizenship contributions, but the very nature of the employment arrangement is altered, restricting it to strictly economic exchange. We infer that strict economic exchange refers to limited exchanges of well-specified services for compensation, the transactional contract. Interestingly, Organ argues against transactional contracts evolving into relational ones, saying that perhaps social pressure might force people who treat others in a transactional way to broaden their contributions, but his tone expresses doubt that accountants might ever become good citizens!

Summary. Citizenship suggests that from a contracts perspective:

1. Extra-role behavior is linked to existence of a relational contract.
2. Perceived fair treatment is critical to the continuation of a relational contract. Absent fairness, member contributions become more limited and arrangements between employee and employer become more transactional.
3. It may be difficult for a transactional contract to grow into a relational one.

THE DYNAMIC NATURE OF CONTRACTS

Together organizational and individual models of contracting provide a basis for describing the emergence, development, modification, and fulfillment of contracts. They also raise questions regarding the nature of hierarchies, the operation of contracts in an organizational context, degrees of contract voluntariness and our ability to create contracts across a spectrum of human needs and concerns.

A general set of premises emerge from the above literature review:

- Models of single episode contracts or transactions (as in classic agency theory) do not generalize well to multi-period contracts or relationships. For most forms of employment involving organizational membership, relational models are more relevant.
- Mutuality of contract terms is subject to effects of different frames of reference and cannot be assumed.
- Acceptance of contract is subject to voluntary participation in the relationship, and can vary depending on contract history and organizational changes (e.g., new ownership).
- Contract parties with multiple agents or contract makers (e.g., many managers) are likely to create non-mutual contracts.
- Promises in multi-party contracts (e.g., involving more than one employee) arise from observation as well as direct expression (witness and survivor effects).

In the context of these premises, we outline a framework characterizing the dynamic nature of contracting and specify propositions which arise from a consideration of theories related to contracting by individuals and organizations. Note that propositions included here are not comprehensive by any means. Rather they serve to sketch implications of a contract framework for understanding behavior in organizations.

Contract Creation

Organizations and individuals create contracts through communications at critical junctures or personnel actions in the employment relationship: recruitment, job change (including promotion and lateral moves), and organizational change and development (e.g., team building, restructuring). These personnel actions signal both commitments and required contributions and a context for employee acceptance of the contract's terms. Messages containing employer promises come from organizational history and reputation, formal commitments (Rousseau & Anton, 1988, 1991), the interpretation of procedures and policies (Parks & Schmedemann, 1992) and the experiences of fellow employees (Brockner, 1988). Contracts emerge from experience as well as observation and may in fact be continuously created and renegotiated, through processes of socialization (Van Maanen & Schein, 1979), feedback seeking (Ashford, 1986; Ashford & Cummings, 1983) and role creation and development (Jones, 1983, 1986). We suggest several general propositions related to the contract creation stage and the evolution of the terms of the contract:

Proposition 1. The longer the duration of the relationship (encompassing a variety of personnel actions and other behavioral events), the more complex and varied will be the contract terms.

Proposition 2. Voluntary personnel actions lead to greater acceptance of contract terms.

Proposition 3. Personnel actions consistent with history and tradition will produce more consensus among parties as to the contractual obligations than those inconsistent with history or tradition.

Proposition 4. The more parties to a contract, the greater the disagreement regarding contract terms among those parties.

Contracts are context-creating. In work groups where contract parties agree (e.g., employee and manager, employees with each other), contract terms act as social norms specifying acceptable and appropriate behavior (as illustrated in Nicholson and John's (1985) notion of an absence culture). Shared contracts are shared normative beliefs which can form the foundation of organizational or subunit culture (Rousseau, 1991).

Proposition 5. Consensus among psychological contracts creates social norms resulting in higher predictability and lower variance in member behavior.

Proposition 6. Longer time frames will facilitate the formation of a consensus among psychological contracts.

All contracts are subject to interpretation (MacNeil, 1985). They are fragmentary due to the inability of parties to specify a priori all the exchanges the contract might cover. Thus, most employment contracts can be characterized as "incomplete" (Simon, 1991). Over the life of the contract, employees typically agree to do what the company asks of them, but those demands will not be specified until some time after the contract is negotiated (Simon, 1951; Williamson, 1975).

Proposition 7. Feedback-seeking will create more complete, well-specified contracts.

Proposition 8. Multiple contract senders (bosses, agents) will create more fragmented and ambiguous contracts.

The diffuse obligations and lack of specificity associated with relational contracts will increase the need for employees to resolve ambiguity concerning the terms and expectations of their contracts. The greater the reliance of the parties on one another, the more they will need to reassure themselves, especially when the strength of the relationship is suspect.

Proposition 9. Relational contracts will be characterized by more feedback seeking behavior.

Proposition 10. "Weak" contracts characterized by high reliance will be characterized by a greater tendency to monitor.

Lack of specificity can give the employer flexibility and aids in the management of uncertainty (Simon, 1991). Still the contract may set some limits on the range of actions employees will be required to perform. These boundaries define the "zone of acceptance" within which an employee can be expected to comply (whether to send mail first class or express could be a matter of indifference to a secretary).

Proposition 11. The longer the duration of the contract the greater the zone of acceptance.

Proposition 12. The longer the duration of contract the more general the contract terms.

Proposition 13. The zone of acceptance will be greater in relational contracts than in transactional ones.

Contract Change

Intrapersonal and experiential factors each contribute to contract change. The passage of time provides opportunity for developmental and cognitive changes in contract parties as well as changes in the organizational context itself.

Contract Drift

Contracts may come to be enacted differently by parties without external intervention. Contract drift occurs when the passage of time alters one's understanding of its terms, due to individual predispositions (e.g., values and cognitive styles). These internally mediated processes involve general human cognitive tendencies toward positive illusions and self-serving biases (Taylor & Brown, 1988) as well as stable personality characteristics and values specific to individuals.

Conservative mechanisms protect against changes in cognitive systems (Taylor & Brown, 1988). Thus studies inducing individuals to credit a partner more than one's self immediately following the task reveal that over time, people give themselves more credit for the joint product—consistent with the general tendency toward self-centered bias. Similarly, contract drift can involve the evolution of contract terms toward seeing one's own side of the bargain as being fulfilled while the other party may continue to owe. Robinson, Kraatz, and Rousseau (1991) found that the obligations new recruits believed they owed their employer declined over time while their employer's obligations increased. Although it is unclear how employment experiences contributed to this divergence in obligation changes, the pattern suggests that self-serving bias can operate in contractual change as they do in other cognitions.

Proposition 14. Over time, a party's beliefs in the level of the other's obligations increases while his or her own obligations decline.

Contractual thinking is related to beliefs about fairness (Rousseau & Aquino, 1992). Over time stable personality characteristics related to fairness beliefs can also impact the psychological contract. Although there is virtually no empirical research on the role played by stable individual personality characteristics in the contracting process, characteristics such as equity sensitivity are related to interpersonal judgments (Walster et al., 1973).

Proposition 15. Beliefs in obligations between contract parties will be related to individual characteristics such as equity sensitivity.

Maturational Changes

Maturational mechanisms may be similar to those Katz (1980) postulated whereby time changes the meaning and stimulus value of job characteristics and other organizational and work experiences.

Proposition 16. As duration of the relationship increases, individuals come to believe contract terms include more relational, socioemotional terms (e.g., support, interest in personal welfare).

Maturation effects include not only changes due to internally mediated experiences but also to the participant's experience in the employment relationship. With time comes increased tenure or duration of the relationship, greater costs of exit, deeper organization-specific knowledge on the part of the employee, greater visibility or social significance attached to the individual's role and more implications for change.

Proposition 17. With duration, relationship-specific assets increase. Conterminously, reciprocal obligations will also increase.

Social Cues

Since behavioral events must be interpreted by individuals to create a psychological contract, changes involve interpretations as well. Salancik and Pfeffer (1978) argue that social cues and social comparisons play an important role in judgements made regarding objective phenomena (e.g., task characteristics). Such social cues as group norms and beliefs others hold about their jobs, their coworkers, or the organization can have profound effects on perceptions, attributions, and enactments. Work groups can have strong emotional and attitudinal reactions to changes such as re-assignments, downsizing, or restructuring. When groups interpret changes negatively (e.g., as their jobs being in jeopardy or the employer untrustworthy), individuals may re-interpret their relationship with the organization and the contract itself.

Proposition 18. Psychological contracts will be influenced by social cues, including group norms, and shared beliefs regarding the firm's actions and intent.

Proposition 19. As individuals become assimilated into work group, social cues will alter their beliefs regarding their relationship to the organization and their psychological contract with it.

Organizational Change

It could be argued that all change is hypocrisy, violating previous commitments, putting the past at odds with the present. New policies and procedures, responses to economic pressures (e.g., by downsizing), management succession and changing leadership styles may send new messages and make commitments at variance with the past.

Proposition 20. Changes in organizational practices and policies increase incidence of contract violation.

Proposition 21. Changes in organizational practices and policies create changes in parties beliefs regarding the psychological contract.

Proposition 22. Changes in organizational practices and policies decrease acceptance of the contract.

Contract Fulfillment

Contract fulfillment has three broad levels: compliance, supra-contracting, and violation.

Compliance

Compliance is adherence to contract terms (e.g., to be absent only the number of days allotted annually as sick leave). Contract fulfillment is a matter of degree. In one sense, when parties perform the conditions specified in the contract, they have complied and it is fulfilled. However, since contract fulfillment can happen over time, in the history of a contract it may be breached at some point but fulfilled latter. Employees may perform poorly initially but improve due to practice or interventions such as feedback and training. Further, one party may fail to fulfill the letter of the agreement but not necessarily violate the contract's intent (to promise promotion at the end of the first year but deliver advancement some time later). *Fulfillment is subject to an individual's interpretation.* Whereas compliance is desirable under most conditions it can be dysfunctional when behaviors are restricted only to those well-specified (e.g., working to contract as a work slowdown strategy in the postal service).

Fulfilling the spirit *if not* the letter of the contract is exemplified in the case of involuntary termination of long standing employees during downsizing (Rousseau & Aquino, 1991). Firms employing severance and outplacement packages make it possible for employees to maintain their standard of living if not their jobs. Remedies to contract violation of comparable value to the terms of the individual's contract (e.g., providing advance notice and ample severance and outplacement when terminating loyal and hardworking employees) fulfill the spirit of the promises made (e.g., by impacting the employee's future well-being; Rousseau & Aquino, 1991). Such a model suggests that social accounts and other justifications for unpopular management actions (with little impact on future employee well-being) would be less likely to fulfill the employer's obligations to the employee (Bies, 1987; Bies & Moag, 1987), although accounts may make termination seem less unfair. As in the case of major organizational changes which impede the fulfillment of the letter of a contract, management of organizational change may walk a fine line between contract fulfillment and violation.

Proposition 23. Contract breach will not violate the contract if remediation of comparable value is offered.

Compliance may be a range rather than a point on continuum of contract fulfillment.

Supra-contracting

Supra-contracting goes beyond specific requirements to include extra-role behaviors similar to those Organ (1990) describes as citizenship. When significant contingencies and appropriate responses cannot be anticipated (e.g., due to technological uncertainty or high degrees of interdependence), it may be important for the parties to go beyond the contract (Parks, 1992). Citizenship behavior can be regarded as actions going beyond the contract—doing things which will not be regarded as breach if they are *not* done.

Proposition 24. Relational contracts will promote higher degrees of citizenship behavior than transactional ones.

Proposition 25. Relational contracts will lead to higher individual performance and labor productivity under technological or environmental uncertainty or where work in the organization is highly interdependent.

Since contracts are bilateral, employers may also act as supra-contractors, acting as a "good general" toward the employee whom Organ (1990) has described as the "good soldier."

Proposition 26. Relational contracts will lead to higher degrees of organizational support and beneficence to employees (e.g., investments in staff development).

However, when uncertainty derives from the environment itself (e.g., business cycle instability), the extensive commitments associated with relational contracts may constrain rather than give flexibility (as characterized in the make and buy distinction in human resource systems; Miles & Snow, 1980; Rousseau, 1989).

Proposition 27. Transactional contracts promote higher individual performance and labor productivity under environmental uncertainty.

Contract Violation

Failure to meet contract terms by either party damages the other, forcing them to incur costs the contract was created to avoid. When contracts are violated, the relationship upon which they are based is also damaged. Trust, once lost, is not easily restored.

Proposition 28. Contract violation erodes trust, undermines the employment relationship yielding lower employee contributions (e.g., performance and attendance) and lower employer investments as well (e.g., retention, promotion). Once violated, relational contracts become transactional.

If a person robs a bank and is caught, giving the money back is not typically treated as sufficient compensation to restore the robber to society's good graces. The damage constitutes more than just the money taken. Similarly, contract violation subjects the employment relationship to a trauma undermining the factors such as good faith which created the relationship. Restoration of the relationship involves reestablishment of trust (Rousseau, 1989). Remedies to reformulate a relationship include improved communication and interpersonal problem solving efforts (Bies & Moag, 1987).

Proposition 29. Interpersonal process remedies following violation can restore the relationship on which the contract is based and reduce adverse consequences of violation. Initial strength of the relationship enhances success of such remedies.

Economic criteria for decisions to violate or comply with contractual obligations have long been recognized and contracts may even contain incentives to shirk (e.g., Staten & Umbeck, 1982) such as high information costs. Such studies typically examine how contract violation on the part of the employer affects the beliefs of employees. However, employees may also violate the contract. Agency theorists address this issue, referring to the moral hazard problems of agency, such as shirking and opportunism. One mechanism posited by the agency theorists to control agent opportunism is the use of contingent contracts (e.g., Argawal & Mandelker, 1987; Eisenhardt, 1989; Jensen & Meckling, 1976; Kosnik, 1987). In a recent laboratory study, Leatherwood and Spector (1991) examined beliefs about the likelihood that an agency contract would be violated (in this case, trucking violations) in a laboratory experiment. Not surprisingly, increased likelihood of detection deterred employee misconduct, as did increasing magnitude of penalties or punishments. However, the focus on violation fails to consider the strong tendency of contract parties to honor their commitments. Despite economic incentives to breach, Harrison and Shanteau (1991) found substantial resistance to violating a contract even in a laboratory setting without sentient ties. Strong cues were required regarding disincentives to continue employment before the contract was broken by even a plurality of subjects.

Proposition 30. Independent of incentives, contract parties tend to honor rather than violate the contract.

Possibly many so-called contract violations or incidents of shirking reflect different perspectives regarding what was promised rather than an intentional violation. The existence of a long-standing relationship and sentient ties between parties should further strengthen this tendency to honor contracts.

Proposition 31. Incentives to breach will have less effect when a relationship exists between the parties.

CONTRACTS AND HIERARCHIES

It could be said that this paper has been largely silent on issues of power and control, in contrast with models of social exchange (e.g., Emerson, 1981) and of hierarchy (Stinchcombe, 1986a, 1986b) . We have emphasized the volitional nature of promissory contracts. The concept of promissory contract, we argue, speaks volumes for the necessary sharing of power in the creation and fulfillment of contracts in organizations. Indeed, promissory contracts can mitigate some of the asymmetries inherent in hierarchies.

In goal setting research (e.g., Latham & Saari, 1979), acceptance is critical for a goal to be motivating. Acceptance is key to the functional existence and operation of a contract, too. The quality of the relationship between the goal setter and receiver can be sufficient to promote acceptance absent participation in setting the objective. But participation is critical when that relationship is lacking. In contracting, acceptance is predicated on the nature of the relationship on which that contract would rest.

In formulating the construct of an individual's psychological contract, we emphasized that it is not contract law which creates the psychological contract but psychological processes which can be independent of law. Such processes for creating promissory contracts are general even if the social and legal norms which might shape them are not. It is risky to assume isomorphism between legal constructs and psychological ones.

From an organizational perspective, the law of corporations developed out of the laws of trust and laws of agency rather than from the law of master-servant relations (Stinchcombe, 1986a). Legally the central feature of a firm is not that it employs people but that it risks someone's money. Employment may not be well understood from a legalistic perspective. Viewing contracts as building blocks for the coordination of work within hierarchies or organizations, we must look to the actual enactments people make of contracts as a basis for understanding and managing organizations.

IN CONCLUSION: WHY CONTRACTS?

Keeley (1988) has argued for a social contract model of organizations, and has suggested that such a model will result in a richer understanding of organizations and organizational processes. We concur. A contract metaphor, like all metaphors, is a way of thinking about complex phenomena (Morgan, 1986)—one that we believe to be beneficial. Keeley (1988) notes that a contract model of organizations eliminates restrictive assumptions, such as the assumption that goals and end products have been agreed upon. Instead, a contract metaphor merely requires an assumption that the parties intend to behave in a particular manner. As noted by Parks and Conlon (1991), a contract perspective has numerous advantages over many of our existing perspectives on employment: goal setting focuses on compliance with specified goals, and like normative models such as agency theory, has difficulty addressing behaviors which are ambiguous or unanticipated, but which may honor the intent if not the letter of the contract; commitment models of organizational attachment are predicated on an intent to stay, whereas a contracting perspective relies only on an intent to complete specific behaviors, however short or long the duration of the contract; unlike typical performance models, a contract perspective addresses both the direction *and* the magnitude components of performance; and finally, the contracting perspective highlights the asymmetries of many of our theories, such as the lack of focus on shirking and adverse selection on the part of the principal in agency theory, or the lack of focus on the "good general" as well as the good soldier in citizenship research (Parks & Conlon, 1991). Finally, a contract model is a mechanism for integrating both micro level and macro level perspectives on organizational behavior: an integration which we believe will not only prove fruitful, but which is essential.

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NOTE

1. MBA quotes were obtained in a longitudinal study of graduating MBA students described in Robinson and Rousseau (1991) and Robinson, Kraatz, and Rousseau (1991).

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