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Changing the deal while keeping the people[1]

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Executive Overview

Companies are in danger of losing the voluntariness that makes possible much of a business's ability to compete. As whole industries undergo restructuring, psychological contracts—those unwritten commitments made between workers and their employers—need to change in order to be kept. Service, quality, and innovation require higher contributions from people and, therefore, a new psychological contract involving commitment and trust. In high contribution work settings, that means changing the deal while keeping the people. Changes which violate a contract or fail to substitute another effective one in its place won't do. And, even though the psychological contract is not legally binding, today's executive must know how successful firms transform it.

Effectively changing a psychological contract depends on two things: how *similar* is the proposed change to the current contract? and how good is the *relationship* between employee and employer? Asking people to use a new work system or work a few extra hours can simply mean to modify, clarify, substitute, or expand an existing contract. However, asking people to redefine themselves—as professionals rather than job holders, customer service providers rather than technicians, or as leaders rather than middle managers—is far more complicated.

When a good-faith relationship exists, changes are more likely to be accepted as part of the existing contract, because parties are not looking for contract violations and trust creates willingness to be flexible.[2] On the other hand, when a relationship historically has been negative, changes are more likely to require more extensive overhaul in the employment relationship. In such situations, improving the employment relationship is a necessary first step in contract change.

Changing the Contract

There are two ways to change the psychological contract, *accommodation* and *transformation*. Accommodations modify, clarify, substitute, or expand terms within the context of the existing contract so that people feel the old deal continues despite changes. Isolated changes in performance criteria, benefit packages or work hours are frequent forms of accommodation. Because of this continuity, it is the change strategy of choice. However, to be effective, there must be a good relationship between the company and its members. Companies such as Hewlett Packard and Cummins Engine have introduced changes in employment conditions over the years that have been largely accepted by their empolyees based on a positive labor history.

In contrast to accommodations, transformations are radical surgery. Transformation means that new mindsets replace old ones. Contemporary contracts are changing at unprecedented rates. Shifts in job duties from individual efforts to teamwork, from short-term financial results to customer satisfaction, or moving from offering "a job for life" to "employability" necessitate the rewriting of the psychological contract. Consider, for example, the transformation of the Bell System. When divestiture was ordered by the courts in the early 1980s, the process of breaking up a highly successful, regulated business and turning it into separate competitive enterprises rewrote the deep structure of the employment contract. Employees who for generations in many cases had "bell-shaped heads" never missed a day of work, and labored loyally for a secure job and retirement began coping with the need to produce business results, and respond to market demands. A decade and a half of uncertainty, terminations, and movement of personnel from operating companies to new high-technology business units radically changed the people and their relationship to the many new organizations that the break-up created.

The purpose of contract transformation is the creation of a new contract that it is hoped engenders commitment. In some cases companies with a history of serious labor/management conflict, such as those in the steel industry, have had no choice but transformation. However, contracts resist revision, and transformation goes against the grain. Therefore, how that change is attempted determines whether change occurs, whether it degenerates into contract violation, or successfully transforms the basis of the relationship.

The fact is that individuals are open to new contract information only at certain times, a phenomenon psychologists refers to as "discontinuous information processing."[3] People often see what they expect to see, gather information only when they think they need it, and ignore a lot. Two circumstances in which people become open to new information are when they are newcomers to the organization or when a disruption occurs which they cannot ignore.

The easiest way to change a contract is to hire new people. Recruits ask a lot of questions while they are newcomers and once they start getting the answers they expect, they stop asking. Veterans may do little inquiring at all. Companies tell things to newcomers that they would never bother mentioning to an old timer. Once norms and practices are internalized, however, the newcomer is no longer new.

Significant disruptions make old mindsets tough to maintain. Several years into a major re-orientation focusing on customers, teamwork, and quality, a Xerox executive encountered a manager who mentioned that he had taken his team with him to go through a refresher training course. He asked why the course was needed given the company's sustained change efforts:

It is quite common to find newcomers and veterans working side by side holding different psychological contracts.

> "Because I never paid much attention the first time through, since I thought this thing would be gone by now, I thought it was just another ice cream flavor. But I got scared when I saw that [the new CEO] had picked it up with vigor. So we know we can't hide in the weeds anymore."[4]

Information gathering tends to be triggered by events signalling "this is the time to ask questions" such as in job interviews, or when the firm has been acquired and a new CEO from the parent company has arrived. Information is processed when there is a felt need for it, when the old information doesn't seem to work, and otherwise pretty well ignored. The cognitive processes involved are both lazy and conservative. People do not work hard on changing contracts or any other established mindset. People work hard on fitting experiences into them. It is quite common to find newcomers and veterans working side by side holding different psychological contracts.

Transformation Stages

Basic principles in transformation capitalize on how employees tend to process information by seeking to unfreeze old mindsets and create new ones, a process characterized here in four stages (see Exhibit 1).

STAGE	INTERVENTION
Challenging the old contract -Stress -Disruption	• Provide new discrepant information (educate people). **Why** do we need to change?
Preparation for change -Ending old contract -Reducing losses -Bridging to new contract	• Involve employees in information gathering (send them out to talk with customers and benchmark successful firms) • Interpret new information (show videos of customers describing service and let employees react to it) • Acknowledge the end of the old contract (celebrate good features of old contract) • Create transitional structures (cross-functional task forces to manage change)
Contract generation -Sensemaking -Veterans become "new"	• Evoke "new contract" script (have people sign on to "new company") • Make contract makers (managers) readily available to share information • Encourage active involvement in new contract creation
Living the new contract -Reality checking	• Be consistent in word and action (train *everyone* in new terms) • Follow through (align managers, human resources practices, etc.) • Refresh (re-emphasize the mission and new contract frequently)

Exhibit 1. Transforming the Psychological Contract

STAGE 1: *Challenging the old contract.* It takes a "good" (i.e., legitimate) reason to change a contract and keep the people. Consider the following scenarios:

> A photocopying shop has one employee who has worked in the shop for three months and earns $9 per hour. Business continues to be satisfactory, but a factory in the area has closed and unemployment has increased. Other small firms have hired reliable workers at $7 an hour to perform jobs similar to those done by the photocopy shop employee. The owner of the photocopying shop reduces the employee's wage to $7.

Is it fair for the employer to cut the employee's wage from $9 to $7 an hour? Now consider the next scenario:

> A house painter employs two assistants and pays them $9 per hour. The painter decides to change businesses and go into lawn mowing where the

going wage is lower. He tells the current workers that he will keep them on if they want to work, but will only pay them $7 per hour.

Is it fair for this employer to cut the employee's wage from $9 to $7 an hour?

These two scenarios have been widely applied in training sessions with executives and consistently yield opposite answers in the vast majority of cases. When first employed, the photocopy scenario led approximately 85% of respondents to say it was "unfair."[5] But the reverse happens in the lawn-mowing situation where a comparable percentage of respondents indicate that cutting the wage is "fair." Each scenario involves the same losses ($2 per hour) and each involves a change proposed by the employer. The difference is the way in which the change is *framed.* The frame in the house-painting scenario involves a shift in the type of business (where the labor market offers a lower wage). There is no legitimate external justification in the photocopy scenario. A core issue in the management of contract change involves how the change is framed.

The reluctance of people to endorse the actions of the photocopy shop's owner suggests a value placed on continuing contracts, especially if losses are involved ($2 per hour), unless there are legitimate reasons to do otherwise. These scenarios highlight a central issue in the success of contract transformation: *effective communication of externally validated reasons for the change.*

Contracts are challenged when discrepant information is available regarding their underlying assumptions. All contracts are based on certain assumptions, including the nature of the business (lawn mowing or house painting, industrial marketing or consumer sales), and good faith efforts to obtain mutual benefits. Shifts in the nature of the business, especially those not directly under organizational control, can create severe costs to either party of continuing the contract.[6] For example, at NCR, management wanted to change the way sales representatives treated customers. To help demonstrate why this change was essential, NCR videotaped major account customers complaining about service and played it to the sales representatives. At first, a few of the representatives denied that the customers had really said anything negative. This denial persisted until one person asked, "Can we see that tape again?" When the video was rerun, the reality of the customer complaints was undeniably clear.

Transformation failures are often directly attributable to failure to justify the contract change or use of insufficient or inappropriate justifications. One defense contract or downsized 10% of its workforce under the banner of "improved shareholder value." With great fanfare, it gave each of the more than 100 top managers in the firm a share of company stock encased in a handsome frame suitable for hanging on the walls of the executive suite. The companywide response was one of resentment, surreptitious conversations behind closed doors, and mistrust of hierarchical superiors. The message sent touted shareholder interests, not those of the corporation generally or the organization member particularly. Unless a person is a shareholder such a message doesn't generate a lot of motivation to change.

A more effective message is that offered by Xerox in the early 1980s following its major loss of market share to Japanese competitors. The CEO, David Kearns, saw a need for greater employee involvement to foster customer responsiveness and corporate competitiveness:

> "It was obvious to me that we had service problems and had never addressed them . . . we dispatched a team of people to Japan. It included plant managers, financial analysts, engineers, and manufacturing specialists . . . Our team went over everything in a thorough manner. It examined all the ingredients of cost: turnover, design time, engineering changes, manufacturing defects, overhead ratios, inventory, how many people worked for a foreman, and so forth. When it was done with its calibration, we were in for quite a shock. [One manager] remembers the results as being 'absolutely nauseating'. It wasn't a case of being out in left field. We weren't even playing the same game."[7]

Results of these analyses revealed that the Japanese carried six to eight times less inventory, had half the overhead and a near 99.5% quality rate on incoming parts compared to Xerox's 95%. Unit manufacturing cost was two-thirds that of the American firm. The product of these insights was a strategy to improve business effectiveness at Xerox with two underpinning concepts: employee involvement and external benchmarking. Commitment to Excellence and Team Xerox are titles of efforts in this strategic change.

Challenging the contract requires creating a deep understanding of the reasons why change is necessary.

Benchmarking—active monitoring of other organizations for establishing performance standards—can identify necessary new mindsets. Involvement helps people exercise these new mindsets. Challenging the contract requires creating a deep understanding of the reasons why change is necessary.

STAGE 2: *Preparation for change.* The goal of this stage is to unfreeze or take apart the old contract while readying the parties for the next stage, creating the new contract. There is a three-pronged approach to effectively managing this stage: creating credible signs of change, reducing losses, and adopting transition structures to bridge to the new contract.

Credible signs of change: we really mean it this time. Critical, undeniable events are needed for people to believe contract change is inevitable. Credible signs of change demonstrate commitment to follow through on the challenge conveyed in stage one, and create an appropriate ending for the earlier contract. Credibility involves different things in different organizations. In a family business where no one but family members have headed the company, the hiring of an outsider could provide a credible signal. In a company whose top management has changed six times in seven years, keeping the same management team on to see a change through may be the necessary signal. This credible sign of change says "this time we mean to change."

The next sign is the message that the old contract is ending. Symbolic ending of the old contract is necessary because people are strongly attached to the arrangement that must have worked well to have survived as long as it did. Some mourning for the old relationship is likely. Respecting the past is part of respecting the people who believed in the old contract. A defense contractor faced with declining markets might celebrate the success of its efforts during the Cold War and declare victory before going on to re-orient its business to new markets. Before initiating a new contract, an old one needs to be completed.

Loss reduction: losses are more painful than gains are good. Given that any gains are not yet realized, at this stage of transformation the sense of loss exceeds gains. Major forms of loss are palpable departures from the status quo (e.g., security, status), emotional distress due to change, and the loss of certainty. Offsetting such losses involves both remedies such as training, and use of procedures that put greater information and control in the hands of people affected by the change. Loss of control and certainty typically accompanies changes, but can be offset by involving individuals in planning the changes that will affect them. When Ameritech began using downsizing through early retirement as part of its change process, employees were permitted to select their date of retirement—any day of their choosing within the calendar year—which maintained some sense of personal control and dignity.

Transition structures: when you can't get there directly from here. Few transformations occur all at once, as evident in the decade of change in the Bell System. Quite often they occur due to major external upheavals, which means that the full scope of the change cannot be known at the beginning and therefore changes cannot be implemented all at once. For psychological contracts to change, these transitions usually involve transitional structures, temporary practices used to promote the larger contract change effort.

Organizations that create new contracts among new hires while honoring existing ones with veterans seek to transform contracts gradually. However, the downside of such gradual transition strategies is that veterans can feel insecure about the continued benefits they obtain while newcomers may feel inequitably treated. It may be that phased-in change using two-tiered wage systems requires some form of phase-out system too, where veterans need support in learning and adjusting to new performance criteria.

Aside from phased-in changes, other transition structures can take on the form of task forces for people to look into ways of effectively introducing or managing change. Such structures are often critical in transformations because conventional communication channels are insufficient for affected individuals whose anxiety levels and information needs have skyrocketed. Having task forces that cut across several functions, areas and levels can aid transformation planning both through the information they gather and what they share. To maintain trust, it is important to have rich information channels, conveying both bad news and any other relevant information in a timely way.

Another transitional structure is an interim contract. Change breeds uncertainty. Reactions to it may vary from overt displays of emotion and frustration to passive withdrawal—"lie low and keep your head down and you might not get shot." When past certainties are gone and nothing yet takes their place, a sort of "no guarantees" or "anything goes" type of relationship prevails, resulting in passive vigilance where little real work gets done. A more functional transition is creation of temporary transaction-like contracts. When the longer term is not knowable and specific commitments cannot be made, it is useful to specify short-term objectives (e.g., project orientation) that give people a clear task and provide support to make that task a success. During this transition, managers need to remain readily available for questions and to convey whatever information they know when they know it.

STAGE 3: *Contract generation: creating a new mindset.* Shotgun weddings don't create new contracts. People need to *want* to be a party to a contract. New commitments are needed that shift attention from the past to the future. Managers generate contract terms by conveying new expectations and commitments. Absence of commitments undercuts the contractual nature of the new arrangement, generating compliance only until a better job opportunity comes along. But when top management makes a clear statement of new terms and solicits commitment to these terms, the supplanting of one contract by another can occur. The terms Jack Welch posted on the wall at GE are an exemplar of a contract-making statement.[8] But, since even strong statements by top managers can be incomplete reflections of a new deal, employees must still inquire, observe, and monitor to understand the scope of the new contract.

Understanding new contract terms requires employees to act like newcomers, regardless of how long they have been with the organization.

During transformation, many earlier contract makers are still intact. Compensation systems and senior managers may continue sending the old contract message into the new era. Old and new contract messages have to be sorted out by employees. Getting the right message out can mean having top management, not the training department, do the training. When Jerre Stedd initiated a globally integrated manufacturing and sales strategy for Square D, he created both Vision Mission, a statement of the Square D's values and goals, and Vision College, a corporation-wide program where he, his managers, and employees from all levels acted as trainers to help veterans and newcomers understand the new mission. The result was rapid dissemination and broad awareness of the new mission.

Understanding new contract terms requires employees to act like newcomers, regardless of how long they have been with the organization. New contract acceptance by veterans is aided by evoking a "new contract script;" for example, by signing a contract, recruiting for a new job within one's current company, or attending a "new employee" orientation. RR Donnelly, in the midst of a major culture shift, transferred veteran employees from its traditional core publishing business to its high-tech information services division, but required them to be treated like a new employee in the process. Veterans submitted a résumé, underwent interviews, testing, and a new employee orientation before actually signing a new employment contract that stressed the importance of teamwork, innovation and customer service.

Signing a new contract signifies the reader's assent to the deal, especially if the signature follows a statement that the employee has read and understands the provisions. Acceptance of new contract terms is also enhanced by having employees:

- adopt a new frame of reference—transfer them to a new job or new organization within the same parent company
- actively express a choice—have them bid for a new job, fill out an application and/or participate in other recruitment-related activities
- convey commitment vividly and publicly—have them sign a written agreement and/or complete a new employee orientation
- Publicly demonstrate acceptance—have them participate in training others to support the change
- become part of a critical mass of people with the same contract—create a contract that is widely shared and understood.

STAGE 4: *Living the new contract.* Some reality testing is part of the transformation process. People may wonder what will happen if someone reverts to the old ways. The aftermath of the U.S. Navy's Tailhook scandal with charges of harassment but few resulting convictions led to a public commitment on the part of the U.S. Navy to change the environment for its female members.

Navy women as combat pilots and aircraft carrier personnel are signs of change since these roles were previously forbidden by both custom and act of Congress. When Lieutenant Sally Fountain, 31-year-old electronic warfare officer on a radar-jamming plane, telephoned a repair office on the carrier *USS Eisenhower,* a male sailor answered and called to his boss, "Hey there is a lieutenant chick on the phone for you." Minutes later, the sailor's angry supervisor hauled the young man before Lieutenant Fountain to formally apologize.[9] Such events are part of the reality check that occurs when work roles, norms, and contract terms change. All contract makers, executives, managers, staff, and employees must be vigilant to reinforce the new contract terms so these can then become part of the taken-for-granted reality of the new contract.

Until employees know with certainty that the "old deal is over," the new contract is not reality.

Solidifying the new contract means that *for a while* the organization has to strive to be incredibly consistent. Until employees know with certainty that the "old deal is over," the new contract is not reality. Managers, senior executives, interviewers, co-workers, and human resource practices (e.g., performance reviews and promotions), all must be on the same page, sending consistent messages in line with the new contract. Focus groups and informal networks can help test whether the new contract is well understood. Until the new deal is taken for granted, the organization cannot afford to send mixed messages. Training *all* contract makers, from senior managers and recruiters, to co-workers and staff, is critical to contract change. Refreshing and reinforcing that training is important to sustaining a new reality.

Toward Continuous Change

Today's new contracts feature active, ongoing renegotiation by both employee and employer.[10] A more diverse workforce needs flexibility in working conditions, prompting employee-driven renegotiations of the contract. At the same time, a more competitive marketplace demands frequent change in the deliverables required (e.g., shorter cycle times, high quality) and the way they are produced (e.g., worldwide, customized), and drives organizations to reformulate contract terms. Sustained performance and strategic focus require psychological contracts that balance and join the interests of people and organizations.

But there is a problem. Restructurings in the 1980s led to an era of "no guarantees," an employment relationship involving no contract at all. Organizations in the throes of change over several years, downsizing frequently, and changing strategy often (which effectively means having no strategy at all) can undermine their ability to successfully manage and motivate a workforce. Though uncertainty may be necessary in the transition to a new contract more in line with competitive strategy, organizations too long in transition erode their *capacity to contract.* When employees don't trust their bosses, react with disbelief to would-be contract making executives, change agents, and training programs, and respond to escalating change with passivity ("keep your head down and this too shall pass"), the organization may have lost its ability to create contracts based on voluntary commitment and good faith. Restoring and protecting the capacity to contract is essential to managing contract change.

How can organizations and their members improve their ability to make and keep contracts? Acting in good faith and signalling concern for each other's interests are obviously important. But blind faith won't do. Active renegotiation of contracts over the long term requires employees to have a good understanding of the nature of the business, its strategy, market conditions and financial indicators. Change cannot be legitimated if people don't understand the reasons for it, nor can they effectively participate in crafting appropriate new terms. The same holds true for employee-initiated changes where managers need perspective on matters outside their own experience. Improving the capacity to contract effectively involves acquiring relevant information and the skills to use it while working to make the relationship stronger.

The present and future psychological contract is increasingly a balanced one where adjustments are inevitable on both sides. The most powerful contracts of all are those that can be both changed and kept.

Endnotes

[1] This article is adapted from D.M. Rousseau, *Psychological Contracts in Organizations: Understanding Written and Unwritten Agreements* (Sage, 1995). An earlier version was presented at the International Consortium for Executive Development Research, Lausanne, Switzerland, June 1994.

[2] The willingness to be flexible in a well-founded relationship has been referred to as the "zone of acceptance." Herbert A. Simon [*Administrative Behavior*, 3rd edition, (New York, NY: Macmillan, 1976)] used this term to refer to the range of duties and responsibilities in a job that employees believe to be under the discretion of their employer. So for example, whether a secretary sends a letter first class or by overnight delivery matters little to that person since both can be thought of as part of mailing correspondence. This zone of acceptance is quite elastic, being broad and open in more relational forms of employment or narrow and rigid in more transactional ones (Rousseau, 1995).

[3] The distinction between systematic and automatic information processing is detailed by H. Sims and D. Gioia in *The Thinking Organization* (San Francisco, CA: Jossey-Bass, 1987).

[4] D.T. Kearns and D.A. Nadler, *Prophets in the Dark: How Xerox Re-Invented Itself and Beat Back the Japanese* (New York, NY: Harper, 1992).

[5] D. Kahneman, J. Knetsch and R.H. Thaler, "Fairness and the Assumptions of Economics," *Journal of Business*, 59, 1986, S285-S300.

[6] The slow adoption and in many cases frustrating failures of the quality of work life (QWL) movement in the United States can be attributed to a lack of any understood legitimated reasons for change in the contract. Quality of work life programs (e.g., Rushton project as described in P.S. Goodman, *Assessing Organizational Change* (New York, NY: Wiley, 1979)) were introduced to address declining productivity. However, there is ample evidence that the threat of foreign competition—in particular from Japan—was not perceived by many managers and employees in large companies such as General Motors and IBM. QWL efforts in the late 1970s were frequently disbanded. A turning point in organizational change efforts came with the total quality movement of the 1980s in which the popular use of benchmarking made it more likely that organization members would look at their firm's competition for information on the firm's relative health and look to other firms even in unrelated industries for best practices and innovations. In investigating the history of organizational development and change, a contracts framework suggests that it is important to ask how the change process was legitimated and whether externally anchored reasons were offered (as in the case of changing one's business from house painting to mowing lawns or from defense contractor to consumer products).

[7] Kearns and Nadler, *op.cit.*, 236.

[8] Described in both the 1992 GE Annual Report to Shareholders and in Robert Slater's, *Get Better or Get Beaten: 31 Leadership Secrets from GE's Jack Welch* (Burr Ridge, IL: Irwin, 1994), this famous statement specifies the four scenarios for GE employees depending on whether they meet commitments and share GE values.

[9] "Navy women bringing new era on carriers," *New York Times*, February 21, 1994.

[10] New psychological contracts increasingly take the form of "balanced contracts" in which both employee and employer (and often also customer and supplier) each have performance terms to live up to and high investments in the relationship and in each other (Rousseau, 1995).

About the Author

Denise M. Rousseau is a professor of organizational behavior at Carnegie Mellon University and researches the impact of work group processes on performance and the changing psychological contract at work. Her books include: *Psychological Contracts in Organizations: Written and Unwritten Agreements* (Sage), *The Boundaryless Career* (Oxford) with Michael Arthur, the *Trends in Organizational Behavior* series (Wiley) with Cary Cooper, and *Developing an Interdisciplinary Science of Organizations* (Jossey-Bass) with Karlene Roberts and Charles Hulin. Other articles for executives include "Teamwork: Inside and Out" and "Managing Diversity for High Performance,"

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Executive Commentary

Edward Ridolfi, McGraw-Hill

Nowhere is it more apparent that the world is changing than in business and industry. Prompted by a variety of environmental forces, companies have undergone substantial change in their strategies, structures and processes. Government regulations, sophisticated consumers, competition from multiple fronts, the breakdown of traditional barriers to market entry, the impact of technology, downsizing, and the emergence of new distribution channels linked to technological advances have all contributed to the pace and scope of change.

As a result, organizations are no longer able to finance or manage responses to change that are fundamentally incremental, evolving over time in an orderly manner. For one thing, Wall Street and company shareholders will not agree to forego short-term profits for the sake of potential long-term gain. The playing fields of business are littered with casualties; that is, corporations unable to maintain payments on term profit commitments that were subsequently abandoned by investors. Concern for short-term profit and short-term results is forcing businesses to make policy and structure changes without serious consideration of either existing or implied psychological contracts with employees.

This reality has irreparably damaged the good-faith relationship that has existed, to one degree or another, between management and employees. The author suggests altering the psychological contract through accommodation or transformation in which companies can adjust the old conditions to fit the new requirements or toss out the conditions and replace them with altogether new ones.

In my estimation, a stipulation for both strategies needs to be that the responsibility for change needs to be shared by employee and employer. Employees must accept those events which have occurred over which their companies had little control. They need to reframe their relationships with the organization in ways that parallel the company's response to its environment by demonstrating flexibility and adaptability. The "used-to-be's" must give way to the realities of "what is and what will be." Finally, employees must be willing to move into uncharted areas in their relationships with employers. They need to see such movement as opportunity rather than obstacle.

An examination of the needs and wants of the organizational talent base must precede the contract and contracting process in companies. The cost of lost intellectual capital and heavy turnover should also be factored into this examination. Questions such as "Where will the next generation of managers be found?" "What will it take to grow and retain talent?" are among those that need to be considered. Hopefully, such actions will produce some innovative approaches in which employee development and company profit needs are jointly met.