ARE EMPLOYEE SELECTION AND INCENTIVE CONTRACTS COMPLEMENTS OR SUBSTITUTES?

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ABSTRACT
There is a debate in the literature as to whether employee selection is a substitute or complement to incentive contracting. We argue that incentive contracts and selection can be both complements and substitutes conditional on the contracting difficulty faced by the firm. We examine these control choices in a setting where contracting difficulties arise due to the firm’s choice of strategy and from the volatility created by the firm’s external environment. We select a firm’s commitment to organizational learning (OL) as our strategic choice variable as this provides a useful proxy for identifying settings where explicit incentive contracting is difficult. The results indicate that as firms become increasingly committed to OL, incentive contracts and employee selection operate as complements. However, for firms that are highly committed to OL, we find evidence of a substitution effect, with the trade-off between selection and incentive contracting depending on the firm’s external volatility.

Key words: employee selection, incentive contracting, strategy, organizational learning