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# Discussion: Do common inherited beliefs and values influence CEO pay?☆



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The origin of preferences is something we know strikingly little about in economics. Given the central importance of preferences, we have not invested nearly the time we should into this. And so, as an overarching research direction, I am heartened by the push of the paper.

That being said, while I believe the authors have done much throughout the writing and revision of this paper, I do believe a number of gaps remain. These gaps vary in their severity – from further explorations that could have better established a potential mechanism, to fundamental gaps that impact inference and bottom-line takeaways. I'll split the discussion into three main sections that encompass what I believe to be three broad categories of these gaps:

1. Two-sided matching.
2. External validity.
3. Lack of consistency across decisions.

## 1. Two-sided matching

The CEO-firm employment match, along with the observed contracting outcome, are both observed equilibrium outcomes of a two-sided match and negotiation. The extent to which either sides' preferences are strongly or systematically observed in the contract will depend on the relative bargaining power of each side, which will be determined by the:

- i. Supply of - demand for – close substitutes in terms of firms and CEOs,
- ii. CEOs' general level of talent,
- iii. CEOs' relative importance in the production-function of the given firm, etc.

These are largely ignored in the paper. Ignored also is the fact that all Boards of Directors understand how important compensation is in addressing the principal-agent problem. Thus, they have formed specialized committees for this: Compensation Committees – which exist at nearly every firm. Given that the compensation contract is negotiated and agreed upon by both the Compensation Committee and the CEO, it is odd that the inherited beliefs of values of only one side are posed as entering the contract.

☆ This discussion was prepared in conjunction with the paper “Do Common Inherited Beliefs and Values Influence CEO Pay?” (Ellahie et al., 2017).  
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Also, these are equilibrium contracts that have been accepted at-will by both sides. No side was forced into accepting the contract. Thus, as both sides have exchange rates for any given contract attribute, the attributes observed could additionally be impacted (even controlling for bargaining position) by which party had the stronger preference. For example, if the Compensation Committee was very reluctant to offer a larger pool of vesting stock grants, there exists a level of fixed salary that would make the CEO happy to accept the contract (even if the CEO preferred these stock grants, all else equal). The level of stock grants thus depends on both negotiating parties' preferences, and the relative strength of each over each attribute.

Examination of the observed contracting decisions while ignoring one entire side of the preferences, along with market conditions, CEO's relative importance at the firm, etc. is a large missing piece of the paper's general set-up and framework. Future research should explore in detail *both* sides of the match. Moreover, if the claim is that a certain attribute should impact observed contracting outcomes, the attribute should – at the very least – be documented for all parties in the contract.

## 2. External validity

I commend the authors for the sheer size and scope of the data they have collected, processed, cleaned, and matched to conduct the study. The headline claim is a global 12-year sample from 2001–2012 of 57,630 CEO-year observations covering 31 countries and 58 ethnicities. Unfortunately, a closer look at the data shows that the dimensionality of variation is a considerably smaller. To be specific,

- Over 75% of the data comes from 4 English speaking countries:
  - o U.S. (roughly half of the data), UK, Canada, Australia
  - o Moreover, these are essentially the UK and three of its former colonies, so also connected ex-ante

This means that the equilibrium contracting process we are seeing is  $\frac{3}{4}$  determined by four rather similar countries (as opposed to 31).

- Over 70% of the data comes from 3 ethnicities in the UK region (English, Celtic, Scottish):

Therefore, much of the variation in “unique ethnicity-based preferences” that the authors are claiming to identify are likely coming from – as are many of the “changes” in ethnicity we see – difference between English→Celtic or Scottish→English. These are simply much more difficult to interpret ex-ante and ex-post as largely different belief and value systems driving different preferences for variable pay. Moreover, given this, and the joint fixed-effect structure of the analysis, it's difficult to assess the true external validity and expected economic magnitude impact of subtle CEO ancestry effects on compensation and other observed outcomes.

## 3. Lack of consistency across decisions

I like that the paper is trying to posit, and then empirically identify, a systematic impact of inherited values and beliefs. However, given the joint fixed-effects identification strategy that is used throughout nearly the entire paper, a truly tractable mechanism never really shines through. Although the paper presents some modest evidence on religion and future reference, what could be much more convincing is seeing these same CEOs making similar types of decisions, and seeing the same ethnicity impacts on those decisions. The paper does examine other firm level decisions such as dividend payouts, cash holdings, and leverage. However, the evidence provided (particularly in Tables 7 and 8 of [Ellahie et al. \(2017\)](#)), do not provide strong associations. In a multiple regression framework in Table 7 Panel C of the paper, essentially none of the “CEO investment preference” fixed effects show a significantly positive relationship with CEO compensation preferences. Again, were the paper truly able to pull out the impact of a systematic ethnicity-based preference, it would have been critical to see more within-agent consistency, especially given that these observed “decisions” were all made at the same firm, over a relatively similar time period, and in a somewhat similar (e.g., financial-based) context.

One of the reasons this may be occurring (which the authors mention in the paper), is that these CEOs are by definition not “average” members of any group to which they belong. By definition, they have been in the top 0.1% of nearly every tournament (e.g., school, hiring firm, within-firm promotion, etc.) in which they have taken part. In fact, many branches of science use CEOs as examples of outliers, highlighting how unlike the rest of the population they are on a host of parameters (e.g., psychology, sociology, etc.). Thus, the fact that it is difficult to identify a robust across-context, ethnicity-preference effect meant to capture large, group consistent, ancestry-based beliefs and values in this selected sample of CEOs may not be incredibly surprising. That being said, it does call into reflection whether this is the correct sample of agents to be looking for this type of effect in the first place.

## 4. Summary

As I began this discussion with, the origin of preferences is a significantly understudied field in economics, despite its first-order importance. While there are gaps that remain in the current work, in sum this paper is a topical step in the right

direction, which will hopefully spur much follow-up work deeply exploring preference-foundations, and their implications for expected and observed behavior.

**Reference**

Ellahie, A., Tahoun, A., Tuna, I., 2017. Do common inherited beliefs and values influence CEO pay? *J. Account. Econ.* forthcoming.