Aligning Incentives with Sustainability Goals:

A Managerial Perspective

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What is the issue?

ESG incentives can align organizational activities with stakeholder demands. However, improperly designed incentives can result in unintended outcomes, such as short-term gains over long-term sustainability or practices that artificially improve ESG metrics without having an actual impact.

Why is it important?

Aligning ESG incentives with personal norms fosters greater engagement and commitment. However, misaligned incentives can result in adverse operational choices to manage emissions, penalize innovation, and stifle progress towards reaching broader environmental goals.

What can be done?

Organizations should frame ESG incentives to align with personal norms while balancing autonomy and clear objectives. Transparent oversight of emissions and scalable metrics, like intensity-based targets or low-carbon revenue growth incentives, ensure accountability and innovation while managing absolute emissions.

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Introduction

More than 90 percent of S&P 500 companies now publish ESG reports in some form, and approximately 70 percent of Russell 1000 companies follow suit, highlighting the growing importance of ESG disclosure.[1] As stakeholders increasingly demand transparency and accountability related to sustainability objectives, companies are under pressure to demonstrate progress on their sustainability goals, which necessitates the need to balance the goals of the principal with those of the agent. Incorporating ESG or sustainability[2] incentives into organizational practices is no longer just a trend but a strategic necessity.

In a managerial setting, the principal–agent relationship is defined "as a contract under which one or more persons, the principal(s), engage another person, the agent, to perform some service on their behalf that involves delegating some decision-making authority to the agent."[3] Ideally, the objectives of principals and agents align, but ESG priorities often require agents to focus on long-term sustainability goals that may not immediately align with short-term financial performance metrics. For example, while principals, such as shareholders or stakeholders, may prioritize reducing environmental impacts or enhancing social equity, agents (e.g., managers) may face pressure to deliver quarterly financial results.

To manage this conflict, principals create employment contracts that not only provide a reasonable economic benefit base (salary) but also include incentives (such as bonuses, etc.) that align the agent's goals with those of the principal.[4] It is important that these contracts include both short-term and long-term incentives that tie in performance measures in order to align the principal's and agent's incentives.[5]

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1 Governance and Accountability Institute Inc. (2021). *2021 sustainability reporting in focus*. https://www.ga-institute.com/research/research/sustainability-reporting-trends/2021-sustainability-reporting-in-focus/

2 I use the terms "sustainability" and "ESG" interchangeably in this article. However, in a technical sense, sustainability relates to the broader construct of the social, natural, and economic impacts on the long-term viability of a company. ESG is more tactical in the sense that it provides a framework focused on organizational environmental, social, and governance performance. The combination of these ESG areas is envisioned to help an organization meet the firm's long-term viability, as understood within the more broadly focused sustainability term.

3 Meckling, W. H., & Jensen, M. C. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, *3*(4): 308, https://doi.org/10.1016/0304-405X(76)90026-X

4 For this article, I use the more technical term of "principal" to mean those decisions made on behalf of the organization's shareholders and stakeholders (including the board of directors and executives when working in this capacity). I use the term "agent" to mean any level of management or employee working as a delegate of the principal.

5 This alignment can be operationalized at multiple levels of an organization. The board of directors, acting as stewards of the principal, can define compensation incentives for upper management that are explicitly tied to ESG objectives. Similarly, upper management, acting on behalf of the board and

Greenwashing

Greenwashing is when companies present themselves as environmentally friendly while their actual practices do not align with these claims.

Greenwashing is damaging as it erodes public trust and "promotes false solutions to the climate crisis that distract from and delay concrete and credible action."

Source: United Nations, Climate Action. (n.d.). *Greenwashing – the deceptive tactics behind environmental claims*. Accessed January 20, 2025, https://www.un.org/en/climatechange/science/climate-issues/greenwashing

As ESG-linked compensation is increasingly seen as a way to drive organizational change, companies with strong ESG performance benefit from better employee engagement and retention and see significant financial advantages. For example, 55 percent of surveyed employees are more willing to work for companies focusing on social and environmental incentives,[6] and businesses with higher ESG scores experience lower turnover rates.[7] Principals face the critical task of effectively integrating ESG metrics into compensation strategies. ESG metrics are now used in 81 percent of executive incentive plans globally, up from 75 percent in 2022, with adoption ranging from 76 percent in the U.S. to 93 percent in Europe.[8] While most companies incorporate ESG metrics into their short-term incentive (STI) plans, measurement in long-term incentive (LTI) plans has also increased, particularly in Europe, where 56 percent of companies now include these metrics. Even in regions like the U.S. and Canada, where adoption of LTI plans has historically been low, prevalence has more than tripled since 2019.[9] Ensuring that these incentives align with corporate values and deliver measurable impact is critical to the success of STI and LTI programs.

Structuring effective ESG contracts requires a balance of financial and non-financial incentives. Bonuses, stock options, or other performance-based rewards can be tied directly to ESG achievements, such as reducing industrial carbon emissions or enhancing workplace diversity. This approach helps counter the typical information asymmetry in principal–agent relationships, where principals may lack visibility into agents' ESG activities. However, contracting for ESG presents additional challenges because of the

stakeholders, can implement ESG-related performance incentives for lower management and other employees. This cascading structure ensures that accountability and alignment with ESG goals permeate throughout the organization, reinforcing a consistent commitment to sustainable and responsible practices.

6 Pérez, L., et al. (2022, August 10). Does ESG really matter – and why? *McKinsey Quarterly*. https://www.mckinsey.com/capabilities/sustainability/our-insights/does-esg-really-matter-and-why

7 Altoe, S., et al. (2024, April 3). Incentivizing change: How ESG-linked compensation can advance sustainability initiatives. *Morningstar*. https://www.sustainalytics.com/esg-research/resource/investors-esg-blog/incentivizing-change--how-esg-linked-compensation-can-advance-sustainability-initiatives

8 Ganu, S., et al. (2024, January 23). *Global report on ESG metrics in incentive plans 2023*. WTW Survey Report. https://www.wtwco.com/en-ca/insights/2024/01/global-report-on-esg-metrics-in-incentive-plans-2023

9 Ganu et al. (2024). *Global report on ESG metrics in incentive plans 2023*.

more qualitative nature of many ESG goals, which can lead to potential moral hazard issues. For instance, agents might superficially meet targets to "greenwash" results rather than genuinely drive sustainable outcomes. While there is much discussion on different types and metrics of ESG compensation strategies, this article focuses on a few areas likely to be overlooked as agents navigate this evolving landscape. Specifically, I'll offer four thought exercises that highlight potential pitfalls related to STI and LTI schemes.

Thought Exercise One: Norm Alignment with ESG Incentives

Economic theory suggests that individuals make choices that maximize their economic benefits or overall financial well-being. From a company perspective, this indicates that investments should focus on options that increase future earnings. However, in an accounting setting, Patrick Martin and Donald Moser[10] provide experimental evidence that individuals will go against their economically rational choices to invest in a socially beneficial option. Specifically, Martin and Moser demonstrate that individuals include non-economic (e.g., sustainability-focused) criteria in their decision set and will invest in sustainable choices that are economically detrimental to the decision-maker. The implication for companies is that agents are willing to balance investing in options with the highest economic outcome with those including higher sustainability-focused outcomes. Other research studies and anecdotal examples have supported this finding. If individuals include personal normative factors in their decision criteria, compensation contracts need to reflect these normative factors. But how?

This thought exercise draws on the study by Bryan Church and colleagues[11] who explore the impact of personal norm alignment within the sustainability setting. They observe that companies increasingly decentralize ESG-related decision-making from centralized executives to local managers, as local managers better align with local needs. However, this more autonomous decentralization creates new challenges in ensuring that ESG initiatives are implemented consistently across the organization. Their study identifies that aligning personal norms with ESG initiatives can effectively incentivize prosocial choice.

Consider this question: Should it matter whether a firm donates cans of food or the equivalent dollar value to buy the same number of cans? Standard economic theory

10 Martin, P. R., & Moser, D. V. (2016). Managers' green investment disclosures and investors' reaction. *Journal of Accounting and Economics*, *61*(1): 239–254. https://doi.org/10.1016/j.jacceco.2015.08.004

11 Church, B. K., et al. (2019). A dollar for a tree or a tree for a dollar? The behavioral effects of measurement basis on managers' CSR investment decision. *The Accounting Review*, *94*(5): 117–137. https://doi.org/10.2308/accr-52332

would suggest that these are equivalent because the economic value of the cans of food is the same in either case. Thus, the decision should not change the personal incentives of the decision-maker. Church and colleagues theorize that despite economic theory, by framing the ESG initiative in a non-financial way (e.g., donating food cans), agents will invest more than when it is presented as a financial investment (i.e., donating an equivalent dollar amount) – BUT, only when agents' personal beliefs align with the social norm of the ESG initiative.

To test this precept, Church and colleagues use an experiment with a scenario where participants decide on resource allocation for an ESG project focused on tree planting. When the initiative is presented in non-financial terms (e.g., focusing on the number of trees planted), it aligns the company's tangible impact on prosocial causes with agents who measure higher in ESG norms (i.e., are more supportive of sustainable initiatives). In turn, these agents are more inclined to support the initiative than those agents measuring lower in ESG norms, even when it involves a personal financial trade-off. Conversely, by framing the ESG initiative in financial terms (e.g., investing dollars to plant trees), agents consider the decision through a traditional cost-benefit lens. Thus, no personal norms about supporting ESG are activated, and agents measuring both high and low in ESG norms invest in a more traditionally economically focused manner, which does not highlight ESG investments over personal financial impacts.

These insights underscore the importance of aligning ESG initiatives with the agents' personal norms. Framing ESG initiatives in non-financial terms and aligning these with agents' ESG norms can facilitate increased engagement and resource commitment to ESG goals, thereby enhancing overall ESG outcomes.

Thought Exercise Two: The Boomerang Effect

This second thought exercise is based on a project that extends the research by Church and colleagues from the first exercise.[12]

According to psychological reactance theory (PRT), people may react negatively when they are forced to act in ways that go against their personal preferences. This reaction stems from a perceived loss of freedom, prompting individuals to take actions to regain their sense of autonomy. Applying this theory to sustainability initiatives, research finds that agents' reactions to ESG mandates are likely influenced by their personal ESG norms and level of autonomy in making decisions. As noted earlier, agents generally fall into two norm categories: those who support ESG initiatives and those who do not.

12 The co-authors of this working project are Jordan Bable, Jason Kuang, Jonathon Kugel, and Adam Vitalis.

Non-supportive agents (those generally opposed to or indifferent about ESG initiatives) may view a mandate to support such initiatives as justified if they are incentivized to align actions with organizational goals in support of ESG initiatives. Since they are unlikely to engage in ESG activities independently, these agents recognize that the mandate is an organizational requirement rather than a personal affront. Thus, these agents will likely respond with mild or moderate reactions to the mandated ESG initiative.

On the other hand, supportive agents – those whose norms align with ESG principles – may perceive such mandates differently. They will likely see the directive as an unnecessary restriction on their freedom to act in alignment with their ESG norms. Feeling that their autonomy has been curtailed, these agents may experience strong adverse reactions, manifesting in retaliatory behaviours. This phenomenon, called the "boomerang effect," occurs because they feel their ability to act freely and with autonomy has been undermined.

PRT suggests that these supportive agents who perceive a loss of autonomy will seek ways to restore it. In this context, a supportive agent directed to invest in ESG initiatives might compensate for their perceived loss of autonomy by making decisions in other areas that subtly "penalize" their superiors. In this study's experimental setting, the penalty is manifested by supportive agents returning less profit to incentive-setting managers than non-supportive agents when supportive agents were *required* to invest in the ESG initiative instead of being *allowed* to invest consistently with their ESG-supportive norms. Notably, such retaliatory behaviours were not observed among non-supportive agents, who did not feel the same loss of autonomy.

These findings further highlight the need to consider the personal norms of agents when designing ESG-related mandates or incentives. Mandates that fail to respect individual autonomy, even when aligned with organizational goals, can backfire – particularly (and counterintuitively) with agents who already support ESG initiatives. Recognizing and addressing these dynamics is essential for successfully integrating ESG practices within an organization.

Thought Exercise Three: Green House Gas Scope Shifting

As established earlier, people follow their incentives, which is why compensation contracts can effectively align the goals of agents and principals. However, this is ineffective when agents manipulate earnings to meet these objectives. In this third thought exercise, we look at whether incentives can lead to agents making adverse operational choices to manage emissions.

The Concept of GHG Emissions Scope

Scope 1 GHG emissions are direct emissions that "occur from sources that are owned or controlled by the company, for example, emissions from combustion in owned or controlled boilers, furnaces, vehicles, etc.; emissions from chemical production in owned or controlled process equipment."

Scope 2 GHG emissions are indirect emissions "from the generation of purchased electricity consumed by the company."

Scope 3 GHG emissions are "indirect emissions from a company's upstream and downstream activities as well as emissions associated with outsourced/contract manufacturing, leases, or franchises not included in Scope 1 or Scope 2."

Source: The Greenhouse Gas Protocol. (n.d.). *A corporate accounting and reporting standard*. Accessed January 9, 2025, https://ghgprotocol.org/corporate-standard

Real earnings management (REM) theory suggests that agents may make operational decisions to meet earning targets or financial benchmarks. REM involves actual business activities that impact cash flows and/or operational performance, typically to meet short-term financial targets or to avoid reporting losses, even though such actions may compromise long-term value. For example, REM can include the reduction of discretionary spending such as research and development (R&D), advertising, or necessary maintenance in order to improve short-term earnings. By cutting expenses temporarily, agents can increase reported earnings, though these cuts may ultimately harm the company's competitive positioning and long-term growth potential.

One concern in the ESG space is that agents will manipulate operational practices to address greenhouse gas emissions (GHG) disclosures. There is a patchwork of rules related to reporting Scopes 1, 2, and 3 emissions. However, currently, the reporting requirement for Scope 3 is generally lower than the requirements for reporting on Scope 1 or Scope 2.[13] In response, companies increasingly incentivize agents to reduce Scope 1 and Scope 2 emissions.[14] This leads to a new challenge – the potential to shift these emissions from Scope 1 to Scope 3 through outsourcing.[15] Outsourcing could yield contrasting outcomes, depending on the outsourced organization's environmen-

13 Given that Scope 1 is directly attributable to company operations and Scope 3 is the indirect GHG emissions that are not controlled by the company, I focus the discussion between Scope 1 and Scope 3 emissions.

14 As noted by Ida Hempel and colleagues, "The bulk of the effort to date has focused on Scope 1 emissions…and Scope 2 emissions. Scope 3 emissions…are understood to be larger in scale but more difficult to influence, and therefore less of an immediate focus." Hempel, I., et al. (2023, December 1). *Feet to the fire: How should companies tie executive compensation to climate targets?* Rock Center for Corporate Governance at Stanford University Working Paper. https://ssrn.com/abstract=4668169

15 In fact, Rui Dai and colleagues have found evidence of Scope 1 outsourcing. Dai, R., et al. (2021, January 7). *Outsourcing climate change*. European Corporate Governance Institute – Finance Working Paper No. 723/2021. https://ssrn.com/abstract=3765485

tal practices, potentially presenting either a negative or a beneficial path to managing overall emissions effectively.

In the negative scenario, agents outsource operations to entities with lower environmental standards, effectively transferring emissions to less-regulated or more carbon-intensive partners. This can result in a net increase in emissions across the value chain, undermining both the spirit of the sustainability goals and the company's overall environmental footprint. For example, in 2022, a U.S. company ended its shuttle service for guests travelling between its amusement park and a nearby airport, transferring transportation needs to third parties like taxis and ride-sharing services.[16] This change moved the emissions from the company's direct Scope 1 to indirect Scope 3. If Scope 3 remains undisclosed for this activity, this shift will make it appear that the company's emissions have decreased, even though total emissions may have risen since individual car services generally produce more per passenger than a shuttle service. This approach is, in essence, "greenwashing" Scope 1 reductions, as the emissions are merely relocated, or even increased, rather than mitigated.

Conversely, a more optimistic scenario is possible if outsourcing is directed to organizations with advanced GHG management practices. Companies can achieve a real decrease in overall emissions by selecting partners who excel in emission reduction and operate more efficiently. This strategy could enhance the effectiveness of emissions reduction initiatives and align with broader sustainability objectives, benefiting both the company and the environment.

Thought Exercise Four: Product Innovation Risk

The fourth exercise looks at how incentivizing agents to decrease absolute emissions could have a negative impact on product innovation. In this situation, absolute GHG emissions can increase even if each product becomes more efficient. For instance, consider a widget that currently generates 10 units of GHG emissions per widget. If the company sells 1,000 widgets, the total emissions are 10,000 units. Now, suppose the company develops a more efficient version of the widget that emits only five units of GHG per widget. If the improved efficiency leads to increased demand, resulting in sales of 30,000 widgets, the total emissions will increase to 15,000 units – an overall increase of 5,000 units despite the product's enhanced efficiency. As another example, consider a service provider that optimizes its cloud storage system, thus lowering data processing energy use from 50 kWh per terabyte to 30 kWh per terabyte stored. With this improvement, the company expands its customer base, leading to an increase in data storage from 10,000 terabytes to 50,000 terabytes. Despite reducing energy use

16 Figueroa, J. (2021, January 11). BREAKING: Disney's magical express service ending in 2022 at Walt Disney World. *WDW News Today*. https://wdwnt.com/2021/01/breaking-disneys-magical-express-service-ending-in-2022-at-walt-disney-world/

per terabyte, total energy consumption rises from 500,000 to 1,500,000 kWh, presenting a dilemma where absolute energy and emission metrics don't capture the eco-efficiency improvement.

This dynamic raises questions about how emissions reporting could affect organizational behaviour and incentive structures. To address the absolute increases in GHG emissions due to increased efficiencies, principals need to consider how incentives might be adjusted to accommodate situations where absolute GHG emissions rise due to increased demand for more efficient products.

Here are three possible suggestions:

1. Proportion emissions targets with sales or production volumes. This can provide a more balanced approach by flexing the emissions targets to account for increased production, thus ensuring agents are rewarded for efficiency improvements rather than penalized for sales success.
2. Companies can scale emissions intensity metrics (e.g., emissions per unit of revenue or unit produced). This aligns emissions targets to reflect efficiency improvements better while allowing for increased production.
3. Incentivize principals based on the growth of "green" or "low-carbon" revenue streams. Focus directly on the cleaner revenue streams encourages product innovations with a lower carbon footprint. For instance, a metric that rewards the percentage of revenue derived from low-emission products rather than penalizing absolute emissions growth may align incentives with sustainability goals more effectively.

These adjustments could allow performance metrics to reflect a synergistic view of emissions performance, accounting for efficiency improvements alongside absolute emission goals.

Conclusion

This article provides four cautionary examples where building ESG-related incentives from a traditional economic perspective may seem reasonable but can have unanticipated consequences in other organizational domains. Companies should consider a holistic approach to ESG that accounts for principals' and agents' varying norms and assesses the broader impact of mandated ESG investing. Specific suggestions from each thought exercise include:

1. **Norm Alignment with ESG Goals:** Align ESG initiatives with the personal norms of principals and agents, framing sustainability efforts in non-financial terms to foster prosocial behaviour and resource commitment.
2. **Avoid the Boomerang Effect:** Mandated ESG directives, if perceived as restric-

tive, can trigger retaliatory behaviour among otherwise supportive principals and agents. Respecting autonomy is crucial to maintaining engagement.

3. **Mitigate Scope Shifting:** Incentives to reduce Scope 1 and Scope 2 emissions may lead to outsourcing, shifting emissions to Scope 3 and risking "greenwashing." Companies should prioritize partnerships that genuinely lower total emissions.
4. **Balance Innovation and Growth:** Efficiency improvements can paradoxically increase total emissions through higher production volumes. Incentive structures should reward eco-efficiency and growth in low-carbon revenue streams rather than penalizing absolute emissions.

By carefully tailoring control mechanisms, companies can work towards achieving social goals without compromising operational efficiency in other areas.