

Designing Incentives for Strategic Behavior

How compensation, recognition and advancement shape whether executives pursue durable outcomes or short-term appearances.

Theory session

Advanced

Running case: AsterGrid



Where this session sits

Module 2 shaped behaviour through culture; Module 3 tests it under pressure

MODULE 1

From Founder to
Leadership System

MODULE 2

Culture as an
Operating System

MODULE 3

**Strategic Continuity
Under Pressure**

SESSIONS IN THIS MODULE

3.1 **Designing Incentives for Strategic Behavior**

Aligning executive behaviour with durable outcomes

YOU ARE HERE

3.2 **Leading Through a Company-Defining Crisis**

Preserving judgment, trust and capacity under disruption

3.3 **Governing the Founder's Succession**

Succession choices, safeguards and continuity mechanisms

What this session explains

Why reward systems produce behaviour nobody intended

01 **Measurement is the real incentive**

What gets paid for is what gets optimised, including in ways the designer did not foresee.

02 **Observability decides the design**

When effort on one dimension is easy to measure and another is not, strong incentives distort.

03 **Money is one instrument among several**

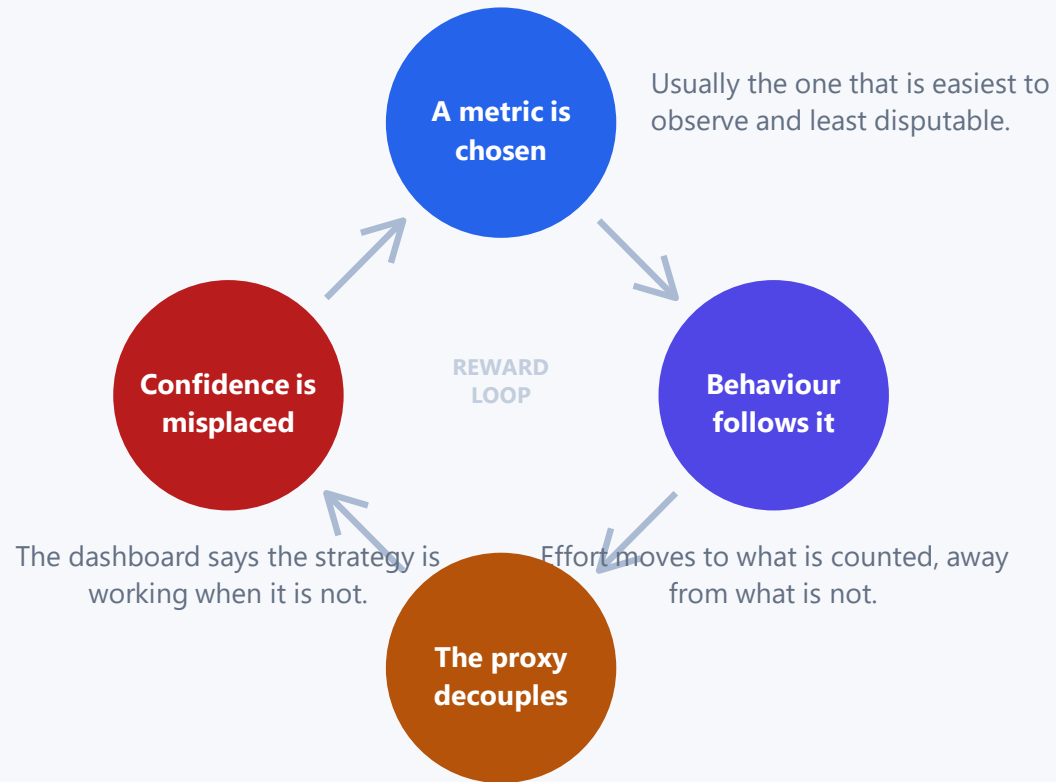
Recognition, advancement and autonomy often carry more weight than the bonus.

04 **Transitions must be staged**

CSI bridged from capacity to output rather than switching the rule overnight.

You get what you measure

Kerr's classic result, which has never stopped being true



Kerr, S. (1975). On the folly of rewarding A, while hoping for B. *Academy of Management Journal*, 18(4), 769–783.

THE CSI ILLUSTRATION

Installed watts are not delivered energy

A badly sited, shaded or poorly maintained array earned the same as an excellent one.

GOODHART'S OBSERVATION

A measure that becomes a target stops being a good measure

Not because people cheat, but because effort reallocates toward the proxy.

THE DESIGN RESPONSE

Measure closer to the outcome

PBI paid on metered generation — one step nearer the thing the programme actually wanted.

Why strong incentives distort

Holmström and Milgrom's multitask result, in one paragraph

WORKING DEFINITION

When a role has several dimensions and only some are measurable, attaching strong incentives to the measurable ones pulls effort away from the rest. The sharper the incentive, the sharper the distortion.

1

The counter-intuitive implication

Where important dimensions are unmeasurable, weaker incentives are better than strong ones.

2

The alternative lever

Change what is measured, rather than increasing the payout on a poor measure.

3

The CSI move

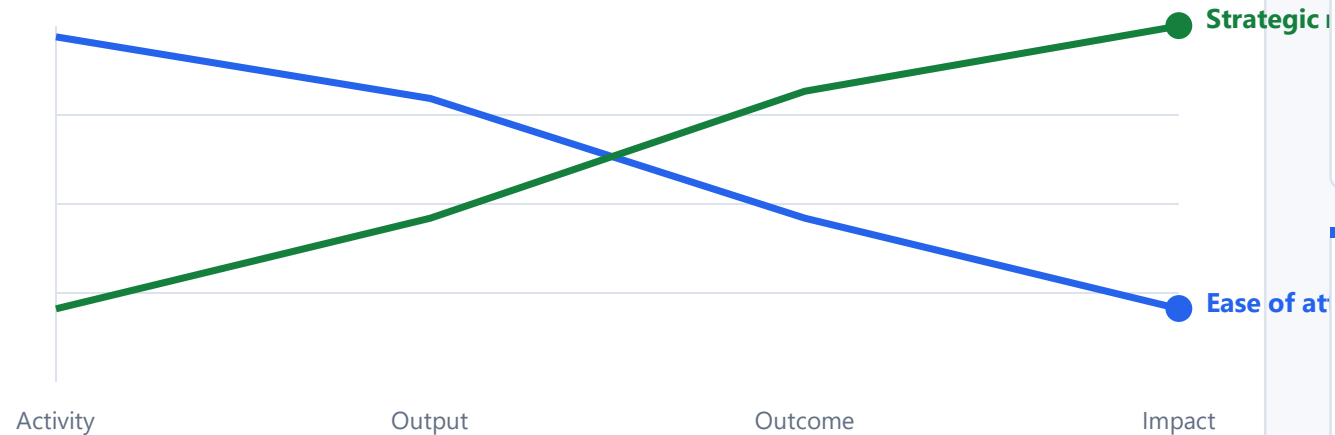
The programme did not raise the capacity payment. It changed the basis of payment.

Holmström, B. & Milgrom, P. (1991). Multitask principal-agent analyses. *Journal of Law, Economics & Organization*, 7, 24–52.

How far the measure sits from the outcome

Closer is better, but harder to attribute and slower to pay

ATTRIBUTION AND IMMEDIACY TRADE OFF
RELATIVE STRENGTH (INDEX)



Activity measures are clean and meaningless; impact measures are meaningful and unattributable. Output and outcome are the working range.

ACTIVITY

Counts of effort

Installations completed, calls made, features shipped. Easy, immediate, and no evidence of value.

OUTPUT

What was produced

Metered kilowatt-hours. Attributable, verifiable, and much closer to the goal.

OUTCOME AND IMPACT

What changed as a result

Carbon displaced, system reliability. Correct, and too diffuse to pay an individual on.

Five reward instruments and what each is good for

Money is the least flexible of them

Instrument	Best used for	Where it goes wrong
Base pay	Signalling the value of the role; retaining people.	Treated as a performance instrument, it becomes a permanent cost of a temporary result.
Variable pay	A small number of measurable, controllable outcomes.	Attached to unmeasurable dimensions, it distorts reliably — the multitask result.
Equity	Aligning senior people with long-horizon value.	Vesting shorter than the strategy's horizon reintroduces short-termism.
Advancement	The strongest signal about what the company rewards — Session 2.1.	Promoting against the stated criteria overrides every other instrument.
Recognition and autonomy	Sustaining intrinsic motivation on complex work.	Recognition that is arbitrary or routine stops carrying information.

THE INSTRUMENT THAT DOMINATES

If advancement and variable pay point in different directions, advancement wins. People read careers more carefully than bonus plans.

Extrinsic incentives and intrinsic motivation

They interact, and not always additively

WHERE EXTRINSIC WORKS

Clear, controllable, countable

CONDITIONS

The outcome is measurable, attributable and within the person's control.

EFFECT

Reliable increases in effort on the measured dimension.

EXAMPLE

Metered generation, where the operator controls siting and maintenance.

WHERE IT BACKFIRES

Complex, interdependent, judgment-led

CONDITIONS

Multiple dimensions, long horizons, shared contribution.

EFFECT

Crowding out — the reward replaces the internal reason rather than adding to it.

WHAT TO USE INSTEAD

Autonomy, mastery and purpose, with pay set fairly and taken off the table.

HOW TO READ THIS CORRECTLY

Deci's crowding-out finding does not mean pay people less. It means pay fairly and generously enough that compensation is not the operative motivator on complex work.

Deci, E., Koestner, R. & Ryan, R. (1999). A meta-analytic review of experiments examining the effects of extrinsic rewards. *Psychological Bulletin*, 125(6).

Matching the reward horizon to the decision horizon

A mismatch produces exactly the behaviour it was meant to prevent

TOO SHORT Quarterly payout on a three-year strategy. Produces pull-forward, deferred maintenance and end-of-period effects.	MATCHED The measurement period spans the time it takes the decision to show its consequences.	TOO LONG Payout so distant it carries no behavioural signal, and people leave before it lands.
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PRACTICAL HORIZON DEVICES

Device	What it corrects
Deferral and clawback.	Results that reverse after the payout date.
Rolling multi-year averages.	Single-period gaming and end-of-quarter distortion.
A quality gate on the payout.	Output achieved by degrading something unmeasured — the CSI workmanship problem.

Changing an incentive rule without breaking trust

The CSI sequence, generalised

THE STAGED CHANGE



WHY THE BRIDGE MATTERED

CSI did not switch overnight. Larger systems crossed a 100 kW threshold to PBI while smaller ones used an adjusted upfront payment through 2007–2008 before moving fully in 2009. The bridge is what preserved participation.

Three incentive designs that produce the wrong behaviour

Each is defensible on paper

Paying for the proxy

Looks like Rewarding installed capacity, pipeline added, or lines shipped.

Why it fails Effort moves to the proxy and the goal stalls.

Fix Move the measure one step closer to the outcome, as PBI did.

Too many metrics

Looks like A scorecard with eleven weighted components.

Why it fails Nothing is salient, so people optimise whichever is easiest.

Fix Three at most, each controllable by the person being measured.

Rewarding the outcome, ignoring the method

Looks like Paying on results with no quality gate.

Why it fails Results achieved by degrading something unmeasured — workmanship, maintenance, trust.

Fix A gate that must be passed before any payout is calculated.

CASE STUDY

California Solar Initiative

An incentive programme that moved from rewarding installation to rewarding delivered energy.

From installed capacity to delivered energy

A payment rule redefining what counted as a credible result

THE ORIGINAL DESIGN

Paying for installed capacity

THE RULE

Upfront incentives tied to rated wattage or capital cost, not to electricity produced.

WHY IT WAS CHOSEN

Deployment was straightforward to measure, and the programme could pay promptly on installation.

WHAT IT COULD NOT SEE

Incorrect equipment ratings, poor workmanship, shading, maintenance and weather variability.

THE REDESIGN

Paying for metered output

THE MECHANISM

Performance-Based Incentives made payment depend on actual metered generation.

THE THRESHOLD

A 100 kW threshold set which systems moved to the PBI structure.

THE TRANSITION

Smaller systems used a site-adjusted bridge (EPBB) through 2007–2008, moving to full PBI in 2009.

READING THE CASE

Incentive design is a measurement problem. The payment rule determines which evidence the organisation treats as proof of success — and therefore what people actually do.

Drawn from the session case pack.

Bringing the theory to AsterGrid

Designing the executive reward system

Step	What you decide	AsterGrid example
Name the outcome	The thing you actually want, before choosing a metric.	Delivered availability across the installed fleet, not units deployed.
Locate the measure	As close to the outcome as attribution allows.	Metered availability per site, measured monthly, attributed to the owning team.
Check the unmeasured	Which dimensions will lose effort.	Maintenance quality and customer response time — both gated, not paid.
Match the horizon	Measurement period spans the consequence.	Rolling 24-month average with a 12-month deferral and clawback.
Set advancement criteria	So careers and pay point the same way.	Published promotion criteria include the gated dimensions explicitly.
Stage the transition	Bridge rather than switch.	Two quarters dual-reported before the new rule determines any payout.

WHAT COMES NEXT

Session 3.2 examines what happens to all of this when a crisis arrives and the measures stop being relevant.

What to carry out of this session

- 1 The payment rule defines what counts as success.**
CSI changed the basis of payment, not the size of the payment.
- 2 Strong incentives on partial measures distort.**
Where important dimensions are unmeasurable, weaker incentives are safer.
- 3 Move the measure closer to the outcome.**
Activity is clean and meaningless; output and outcome are the working range.
- 4 Advancement outranks the bonus plan.**
If they disagree, people follow the promotion decisions.
- 5 Bridge the transition.**
A staged change preserves participation; an overnight switch costs trust.

Sources for this session

Primary references behind each concept

THE CLASSIC	Kerr, S. (1975). On the folly of rewarding A, while hoping for B. <i>Academy of Management Journal</i> , 18(4), 769–783.
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