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## How ESG Pay Metrics Change CEO Incentives

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In new research, Vikas Agarwal, Juan-Pedro Gómez, Kasra Hosseini, and Manish Jha explore how companies reward executives for meeting sustainability targets. They evaluate how ESG metrics to determine executive pay create tradeoffs with traditional financial incentives, and what that means for the future of ESG goals.

**T**he corporate world is in the middle of a massive experiment. Over the past decade, firms have increasingly tied executive bonuses to environmental, social, and governance (ESG) performance—everything from reducing carbon emissions to improving workforce diversity and board independence. What began as a symbolic gesture toward “responsible capitalism” has evolved into a defining feature of modern executive pay.

But as ESG-linked pay expands, a fundamental question looms: how do firms accommodate ESG-based incentives in executive compensation? How do they interplay with the existing ones? In our recent study, “[ESG Metrics in Executive Compensation: A Multitasking Approach](#),”

we explore this issue through both theory and data. Drawing on economic models of multitasking (how firms pursue different goals) and a large micro-dataset of executive compensation contracts, we show that ESG pay reshapes how firms motivate their top executives. The key insight is simple yet powerful: adding ESG goals doesn't just create new incentives. It forces a rebalancing of old ones.

## The multitasking dilemma

Executives, like everyone else, face tradeoffs in how they spend their time and effort. Traditional incentive contracts reward measurable outcomes such as profits, earnings per share, or total shareholder return. ESG goals, however, are harder to measure and often uncertain in their link to firm value. How do you quantify a CEO's contribution to workplace diversity or carbon neutrality?

Economic theory tells us that when a new, less measurable task is added to a job, the optimal contract reduces incentives for the other, easier-to-measure tasks. Otherwise, the executive would ignore the new objectives. This is the essence of multitasking theory—a framework developed by economists **Bengt Holmström and Paul Milgrom in the early 1990s** to explain why firms sometimes prefer weaker performance-pay sensitivity.

Our study adapts this theory to the modern corporate context of ESG pay. When ESG metrics are added to executive contracts, the rational firm reduces the sensitivity of pay to financial metrics. In effect, companies induce their leaders to reduce the pursuit of profit maximization in exchange for enhancing the firm's sustainability.

## What the data say

To test this, we examined more than 22,000 observations of executive pay metrics (i.e., measurable performance criterion), such as improvement in stock price, from 735 companies based in the United States between 2008 and 2023, using detailed data from ISS Incentive Lab. Our measure of incentive power, referred to as the dollar delta, captures how much an executive's wealth changes for every 1% rise in the firm's stock price.

When firms introduced ESG metrics, we found that the dollar delta for traditional financial metrics fell by about 20%—roughly a \$4,600 decline from an average baseline of \$23,500. This pattern remains strong even when we examine the effect for the same executive at the same firm being awarded in the same way and in the same year. Moreover, it reverses symmetrically when ESG metrics are removed from the contract.

The tradeoff grows sharper when firms pile on multiple ESG metrics or rely on vague, discretionary ones. Replacing a single, concrete emissions target with a bundle of loosely defined "sustainability goals" weakens the link between pay and performance. Executives aren't as motivated by ESG goals that are hard to monitor. By contrast, when ESG objectives

are measurable—such as a clear carbon reduction threshold—PROMARKET the tradeoff nearly disappears, making employees more likely to prioritize sustainability.

Our evidence also shows that the dilution of financial incentives is most pronounced when ESG targets are either non-material to a firm’s core business or hard to measure with precision. These are precisely the conditions under which ESG-linked pay risks becoming a form of greenwashing—signaling virtue without delivering verifiable results.

Even so, the rebalancing of incentives has tangible consequences. Firms that shift more weight toward ESG performance see measurable improvements in their sustainability ratings—about a one-point gain in the average ESG score of about 60 points for every one-standard-deviation drop in the sensitivity of pay to financial performance. Yet, we find no corresponding change in near-term profitability or stock returns, suggesting that the rewards of sustainability investments may take longer to emerge.

In short, how firms design ESG metrics and, more importantly, how they redesign incentives associated with other standard metrics matters as much as whether they adopt them. Even if ESG metrics are not (yet) as precise and quantifiable as financial or accounting-based metrics, weakening the incentives associated with the financial or accounting metrics may guide managerial effort toward genuine social and environmental progress.

### **A new equilibrium in corporate governance**

This evidence reframes how we should interpret the ESG pay movement. Critics like **Lucian Bebchuk and Roberto Tallarita** have argued that ESG metrics in compensation provide “window dressing” incentives because it gives boards more discretion to reward or protect executives. Others, including Alex Edmans, **have warned** that linking CEO pay to ESG metrics is misguided because ESG performance is difficult to measure and can lead to distorted incentives. Instead, companies should pay CEOs in long-term shares to align them with sustainable value creation for both shareholders and society.

Our findings suggest a more nuanced reality. ESG pay is neither mere symbolism nor managerial opportunism: it is a rational adjustment to a new governance constraint. Firms are not paying executives more; they are redistributing incentive power. When a task is harder to measure, the optimal contract weakens incentives on measurable tasks to make room for the new one.

This perspective helps reconcile two seemingly contradictory trends: the rapid adoption of ESG pay and the modest role ESG metrics currently play in total executive compensation. Firms are not betting the house on ESG—they are experimenting cautiously, fine-tuning the balance between social responsibility and shareholder value.

### **Policy and governance implications**

The policy ~~takeaway is straightforward: ESG pay is not inherently good or bad—it depends on~~ how it's designed.

- 1) **Boards** should ensure that ESG targets are quantifiable, clearly linked to long-term firm value, and balanced against financial or accounting performance measures.
- 2) **Investors** should scrutinize the structure of ESG pay rather than its mere existence. The reallocation of incentive power can reveal whether a firm is genuinely prioritizing sustainability or simply repackaging conventional pay.
- 3) **Regulators** can improve market discipline by requiring firms to disclose the weighting, measurability, and performance criteria of ESG metrics in compensation plans. Transparency about how these goals are defined would make it harder for firms to claim virtue without substance.

Ultimately, our research shows that firms are behaving rationally within the constraints they face. ESG goals are real, but so are opportunity costs. The task for policymakers and boards is to design systems that recognize both.

## Looking ahead

The introduction of ESG pay marks a turning point in corporate governance. It signals a world where companies are held accountable not just for profits but for their social and environmental footprints. Yet this evolution also underscores a timeless truth about incentives: they must be designed with care. Firms cannot simply add sustainability goals without adjusting other levers of motivation. The challenge for the next decade is to ensure that these adjustments make executives better stewards of long-term value rather than less accountable managers of short-term outcomes. Sustainability, like profitability, is a product of incentives. The question is not whether CEOs should be paid for ESG performance—but how to make that pay count.

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