Reflecting on STIP

The Arbitrum Incentives Working Group successfully transformed a contentious governance stalemate into an imperfect, but ultimately successful, consensus framework. With the DAO's adoption of the framework, delegates allocated 50M ARB in grants across 30 protocols, spurred by over 100 applications from diverse Arbitrum projects.

As the DAO explores initiatives to adjust, extend, and amend STIP, it's worth weighing the efforts spent on rectifying its flaws against the potential of fostering a vision for more forward-looking, sustainable frameworks. The promise of STIP was a compromise to provide potentially shitty network incentives, with the hope that future investments would prioritize values like long-term growth, user retention, and capital efficiency.

As a largely neutral party, I've observed current discourse within the DAO mostly revolves around amending the shortcomings of STIP based on arguments of inclusion and equality. This post aims to frame an entirely different philosophy, positing a shift towards excellence and rigor via grant infrastructure designed primarily to tactically and meaningfully allocate DAO resources towards programs that maximize long-term growth.

A Long-Term Approach

Before STIP's inception, @raho and I spent months analyzing incentives programs, trolling data and forums, to better understand their impact on long-term growth and capital efficiency. While unable to find robust evidence that incentives are an efficacious long-term solution to growth, we often observed their efficacy to attract both users and capital to protocols and ecosystems in short-term periods, and in some cases drive retention.

This is not a novel discovery, but rather context for how the discussions between protocols, delegates, and stakeholders might proceed. As data from STIP comes in, the goal should be to not just make more decisions, for more projects, over more time, for more ARB…the goal should be to increase Arbitrum DAO's investment in the ecosystem with the benefits of meaningful hindsight, and ambitious foresight. We should look to improve not just the consensus mechanism (direct voting = never again) of incentive programs, but the fabric of incentive design, analysis and efficacy.

As evidenced by STIP, the objectives set during a program's design phase critically shape its outcomes. In this context, it feels worthwhile to take a step back to observe a simplistic, but hopefully meaningful philosophy to grants, incentives, and growth.

Grants Programs: A Principled Approach

ARB delegates are responsible for fostering, developing, authorizing, and governing the Arbitrum DAO-governed chains. These governors also maintain the power to allocate and manage all protocol revenue, currently collected by the sequencer and transferred to the DAO treasury.

Assuming Arbitrum network longevity and growth are goals of the DAO, supporting activities that increase sustainable network usage is a meaningful objective for the DAO to pursue. As a proxy for usage, many observe sequencer revenue on the network. Optimism's RPGF Flywheel has gone so far as incorporating sequencer revenue as the engine of a development flywheel to ensure the network's long-term health.

Using sequencer revenue as a signal for network usage, we can observe that Arbitrum generates revenue via fees, observing which predefined stakeholders from the Arbitrum Foundation pay these fees may help inform avenues for grant funding.

These stakeholders hold the potential to drive sequencer fees either directly, through usage of the network, or indirectly, via parameter changes and technical developments that might increase network usage by making the platform more attractive to protocols and users. For this exercise, we'll observe the stakeholders that most directly impact revenue, defining them as:

1. Network Stakeholders

: Chains (ex., Arbitrum One and Nitro) use the DAO sequencer to settle transactions to the Ethereum mainnet.

1. Application Stakeholders:

Applications on Arbitrum chains facilitate transactions to the DAO sequencer on behalf of their users.

1. User Stakeholders:

Users utilize the DAO sequencer to transact, exchange, or use dApps to settle transactions.

Currently, most grant discussions have focused on these direct revenue generators, a motive which is likely appropriate for the Arbitrum DAO's growth stage. The existing grants programs can be broadly broken into three categories of grant funding:

1. Ecosystem Development Grants

: Grants that support the development of products, tools, and services that leverage the Arbitrum network to achieve their goals.

1. Ecosystem Incentive Grants

: Grants that support the usage of products, tools, and services that are built upon the Arbitrum network.

1. Internal Development Grants

: Grants that support the development of internal resources with the intent of increasing the growth of the Arbitrum network (this could include the administration costs, data programs, etc.).

When it comes to grants, we can also observe popular distribution strategies:

1. Development Grants:

Grants allocated towards community builders for pre-defined scopes of work.

1. Incentive Grants:

Incentive grants distribute tokens to protocols, who subsidize usage of the network when interacting with a particular project or protocol, usually in the form of rewards, rebates, etc.

1. Bounties:

Objective-driven Grants require community stakeholders or grant administrators to define explicit objectives. Prospective grantees can achieve these objectives, and receive a bounty grant for doing so.

1. Retroactive Grants

: Completed projects are reviewed based on their impact and granted after completion.

1. Incubation:

A mentorship program to support and foster early-stage development until participating projects acquire sufficient resources to function independently.

A Role for Incentives

Incentives are one tool. They're both fleeting and immediately impactful. As such, they are likely better treated as a spice, rather than a main ingredient. To help further contextualize a potential role for incentives, observing each stakeholder bucket in greater detail can help highlight lessons and further determine the efficacy of incentives for growth:

1. Arbitrum Network Stakeholders

Arbitrum Orbit enables permissionless deployment of new Layer-3 and the Constitution empowers the Arbitrum DAO to permit new Layer-2 chains. The demand for rollup chains is clear as Coinbase, Lens, and Worldcoin have all committed to building on Optimism's OP Stack architecture.

Due to the technical requirements for launching a layer-3 or layer-2 chain, one might expect the Foundation and Offchain Labs to play a critical role in facilitating many layer-3 relationships moving forward. As such, the DAO might consider familiarizing itself with the Foundation's roadmap, objectives, and recruitment strategies to identify blind spots.

That said, avenues also exist for the DAO to both support and fund Arbitrum Network Stakeholders:

- Development fund for new L3 chains.
- Development and incubation program for network chains.
- Analytics, dashboards, and reporting for launched chains.
- Incentive programs to grow usage across new networks and chains.
- Retroactive grants for Arbitrum networks that meet performance benchmarks.

The community might research and consider what resources, incentives, and technical and financial support could provide to help fund the development of equally robust brand names on the Arbtirum Orbit architecture.

2. Application Layer Stakeholders

Layer-2s benefit from supporting dApp development more than existing grant programs at the application layer (Aave, Lido, Compound) since applications drive the majority of on-chain fees. As such, the Arbitrum DAO is incentivized to build a robust dApp network.

Observing trends in application usage, user retention, and transaction volumes across many networks can provide insight into how Arbitrum might approach dApp growth.

- Native and Niche Applications

Ally Zach, an author of User Retention on Optimism and Arbitrum, discovered some interesting findings including the concept that native applications actually bring sticky user retention. Historically, niche applications that leaned into Arbitrum's network strengths as a low-cost environment, such as GMX and Radiant Capital, have outperformed non-native applications in user retention.

The trend of outperformed user retention can also be observed across alt-L1s, who've seen periods of outsized adoption in niche applications such as Lens on Polygon and even Step'N on Solana. When funding dApps, the Arbitrum Grants might emphasize supporting unique, niche, and native applications that provide better user adoption, retention, and transaction volumes, instead of prioritizing the migration of existing applications or forked protocols.

- Arbitrum-Enabled Applications

L2s provide cheaper, faster transactions than Ethereum mainnet. This enables emerging applications that struggled to reach critical adoption on Ethereum layer-1 due to high transaction costs, such as perpetual exchanges, gaming, and decentralized social protocols. One could expect this to enable many new applications and might prefer to see grant funding that supports maverick and novel applications built on this technology rather than merely improved in a low-cost, high-throughput environment.

These two characteristics, which encompass niche, native, and tech-aligned solutions, may better retain users than forked or migrated protocols such as similar mid-tier dexes, perps, and lending protocols. Because of the availability of these protocols, data suggests users will chase any increased yield opportunities aggressively, moving funds to farm short-term rewards but being less compelled to stick around once incentives end or begin elsewhere.

3. User Layer Stakeholders

User adoption programs have existed long before crypto including deals and rewards programs at your local ice cream shop. They also have proven effective in driving adoption for new products, technologies, and services. For L2s, user adoption is often structured via rebates or incentives.

Rebates aim to help subsidize a portion of a network's transaction cost by allowing claims of a native governance token, helping decentralize the number of governance token holders. Rebates can be structured in many ways, including a claimable stipend held in a smart contract or retroactively via an airdrop to eligible users. Near Protocol, Optimism, and Avalanche have all conducted notable incentive programs.

Given the permissionless nature of blockchains, incentives in crypto are particularly vulnerable to being abused by rent-seekers who use these programs to receive rewards without the intention of returning to the products and services they engage with. Takeaways from Optimism's Governance Fund distributions help demonstrate how these types of programs can help boost short-term metrics (TVL, transactions, fees) but have a varied impact when looking at long-term, annualized, and post-program metrics. This is not to say incentives are bad, only to suggest that, as a community, Arbitrum can learn from these lessons to design better and more effective incentive programs.

A large goal of STIP is to internalize these learnings with data, so the community might improve its decision-making moving forward.

Some Areas to Explore:

No one knows incentives better than the protocols who deploy them. Many of these takeaways are well known. But from the admin level, the DAO should focus on rewarding designs and programs that embrace efforts to IMPROVE their capital efficiency, and IMPROVE their odds of retention and long-term growth.

Better Incentive Designs

Incentive design is a powerful tool to generate user traction. One example: Blur, covered in this case study by Spindl, used a dynamic incentive program that shifted over time, offered expectations for long-term rewards, and focused on siphoning volume and liquidity from competitors. While this aggressive approach may not work for all programs, the DAO should work with incentive program applicants to develop specific strategies that are thesis-driven, measurable and improvable.

Designing User Experience

Educational elements in incentive programs may aid in retaining users. At Optimism Galxe Quests actually far more effective at bringing transaction volumes, and new users, than liquidity mining programs (which brought more capital).

Combining these aspects to a more comprehensive UX is worth exploring to further determine the effects of education on future engagement, and adoption. Establishing long-term and recurring reward cycles designed around user experiences should be worth exploring.

Liquidity & User Dynamics

An exploration in DeFi, liquidity provider engagement in relation to user engagement, (Supply/Demand analysis) is potentially under-observed. Observations like understanding of what liquidity thresholds are required (at an ecosystem and protocol level) to catalyze meaningful volume or demand for a given asset should be explored as the DAO looks to bring users to Arbitrum in a competitive L2 environment. Specifically, marrying these insights with user behavior and customer preferences would provide meaningful insight in the design of objective based grants for specific tokens/assets (LSTs, stables, etc.).

Accountability and Transparency

The DAO, Foundation, and all open-source organizations should hold standards oftransparency and accountability. This includes grant programs. STIP took pains to include this despite the rapid deployment of the program via grant streaming w/ Hedgey and self-reporting requirements. Simple disclosures such as the contract addresses used to disburse incentive funding, incentivized pool addresses, etc. helps dramatically when observing the effect of programs overall.

Data Infrastructure

Without the infrastructure to collect meaningful data on the DAO's programs, it's nearly impossible for the community to create meaningful impact. In the long-term, dashboards, analytics, and reporting should be required of all incentive programs, whether funded as an internal effort by the DAO or a requirement of participating programs, Optimism Lab's Analytics program is a great starting point, and Plurality Labs' work to fundOpen Data initiatives are a promising step for Arbitrum.

Granular data is also important. Analysis must be conducted on aper asset, per pool, and per protocol basis, to gain meaningful insights for future grant design.

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Optimization

Great incentive programs also are willing to iterate by experimenting and optimizing their programs. This can be designed at the grant level with planning by the grant provider. The DAO could guide grantees and ask projects to release their incentives in tranches, measure results against pre-established KPIs and provide rolling optimization to deliver effective results.

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Velodrome, an Optimism-native DEX, has been a leader in evaluating OP incentives. Theirprogram analysis post outlines their evaluation framework and key takeaways. Through diligent research, analysis, and effort they demonstrably improved the value returned per OP over time.

For maximum capital efficiency, a robust incentive program would work with grantees to structure objective based grants with metrics and milestones up front, distribution in tranches to measure impact against measurable targets, track performance to identify effective vs. ineffective strategies, build in flexibility to adjust future programs, and perform robust reporting and retroactive impact evaluations to improve future programs for everyone.

Governance Implications

Lost in all this is the actual implications of token distribution on governance. Establishing governance flywheels that analyze claimant participation in governance, their delegation habits, and claimant behavior in general will be essential to ensuring incentive programs align with DAO goals.

What Next?

The next Arbitrum Incentives Working Group meeting invites all interested stakeholders to help brainstorm, pitch, and ideate on future DAO incentives programs:

Incentives Working Group Call

Tuesday, December 12 · 9:00 – 10:00am

Time zone: America/Los_Angeles

Google Meet joining info

Video call link: https://meet.google.com/qhw-irji-dcb

Or dial: (FR) +33 1 73 08 31 91 PIN: 537 628 857 2081#

More phone numbers: https://tel.meet/qhw-irji-dcb?pin=5376288572081

As such, I encourage folks to use this thread to pull in examples of successful programs, call out any ignorance in the aforementioned sections, and help make the next iterations of Arbitrum incentives stronger.

I also have been brainstorming some conceptual ideas…hoping to get those open for public consideration by eow.