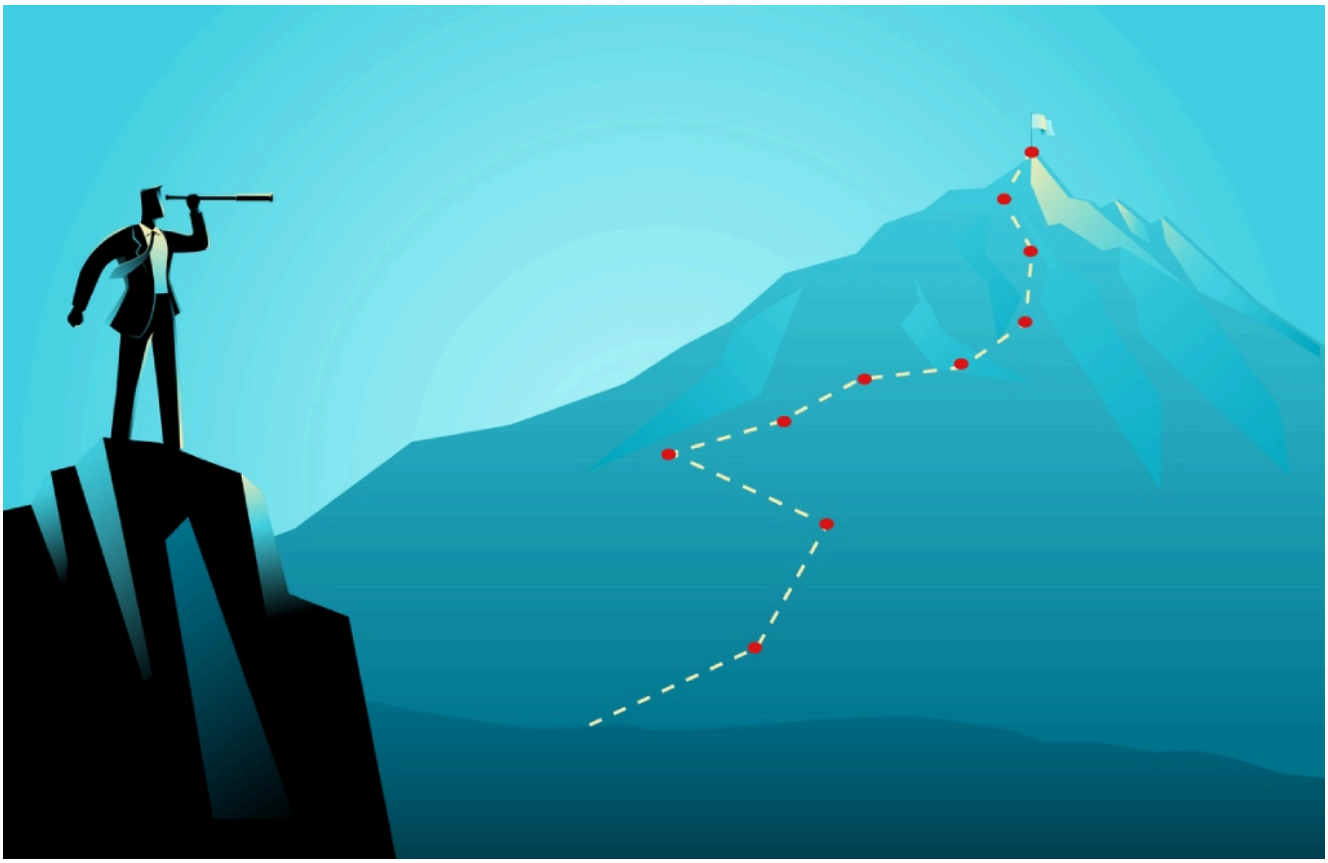
The Tao of target setting

In theory, targets should help motivate employees. But assigning ever-more-ambitious targets in response to positive results can be counterproductive. IESE's Tony Dávila and co-authors study target setting in a large company with hundreds of branches and find that target setting works best when it takes into account the performance of other employees in similar roles.



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If your top salespeople exceed their sales targets, do you raise those targets for the next

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year? What happens if a positive bump was only temporary and your best talent is left discouraged by performance goals that are ever harder to reach?

In other words, what is the best way to set targets that motivate, help with planning, but don't fall prey to the "ratchet effect"?

Carmen Aranda and Javier Arellano of the University of Navarra and **Tony Dávila** of IESE study ratcheting and target setting over five years at a large travel company. They conclude that setting relative targets, based on comparable peer performances and benchmarks, is better than looking at individuals' past performances alone. In other words, relative target setting enhances contracting to help supervisors avoid the ratchet effect, where employees deliberately reduce their efforts to lower future expectations.

The Ratchet Effect at Work

Too often, work targets are routine adjustments based simply on historical performance. This is known as ratcheting. Once employees recognize the predictable pattern, negative consequences may set in.

Over the long run, employees avoid exceeding targets if they know it will inflate future expectations. They may deliberately limit their efforts in a bid to temper future goals. This is known as the "ratchet effect" and it gets in the way of optimal firm performance.

For supervisors, it is key to know if great results come from temporary or permanent improvements. Increased efforts are considered temporary because there are limits to how much individual effort can be increased over time. If targets are ratcheted up, extraordinary (distorted) efforts cannot possibly be sustained over the long run.

In contrast, when productivity gains stem from greater efficiency, such as the introduction of new technology, they are more likely to persist.

A Study of Branches

The co-authors study 376 branches of a large retail travel company. The branches, located in 18 distinct regions, all sell the same products, have a similar size and complexity, and have similar marketing and operations practices. In other words, comparing the branches' performances and target setting practices over five years allows the researchers to glean some very practical insights.

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Taking into account the performance metrics of other, similar units allows managers to observe if positive (or negative) trends are likely to be temporary or permanent and adjust targets accordingly to the new objectives.

The co-authors note that ratcheting targets upwards goes better with permanent efficiency gains, when a rising tide is lifting all ships. In this scenario, individual employees tend to recognize that limiting their own efforts will have a limited impact. In contrast, the savvy managers look to the firm averages to limit ratcheting if their employees' gains came from extraordinary individual efforts.

Meanwhile, shrewd managers set new targets based on general performance results seen throughout the company, and not on positive results that are due to extraordinary individual efforts and are, therefore, unsustainable.

Better Information, Better Targets

Relative target setting can incorporate information from other branches, divisions and even industry competitors. Relative target setting improves the quality of supervisors' targets for better results.

Overall, by having more information to work with — information that looks sideways and not just at the past to set goals — companies can reduce negative effects of ratcheting, while motivating employees more effectively to maximize efforts for everyone's benefit.

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