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CABINET

PERFORMANCE-RELATED PAY

Memorandum by the Minister of State, Privy Council Office

Ever since we took office in 1979 we have accepted in principle the desirability of introducing some form of performance-related pay in the Civil Service. We invited the inquiry into Civil Service pay (the Megaw Committee) to make recommendations on this subject. They did so two years ago. Since then we have committed ourselves on various occasions to considering ways of making progress. But we have done nothing so far, partly because of uncertainty and differences of opinion about the best system of performance-related pay for the Civil Service and partly because of uncertainties about cost.

2. We are engaged upon a profound change in the style and professionalism of management in central Government, with much greater emphasis on value for money, on the clear definition of objectives and personal accountability for results, and on the dispersal outwards and downwards of financial responsibility. We have already taken a number of important steps, including the Financial Management Initiative and the introduction of a programme of reform of personnel work. We need to support this programme of change by encouraging good performance and improving motivation in the Civil Service.

3. Motivation is not of course just a matter of money, particularly in the public service. Some would argue that performance-related pay, other than that which results from the system of promotion in a hierarchical structure, is alien to the culture of the public service. But many organisations, in the public sector as well as the private sector, have adopted performance-related pay arrangements, and such arrangements are a feature of pay systems in public services in many other countries. There must be at least a presumption that there is a link between motivation and financial reward which would be valid in the public service no less than elsewhere. We can test this presumption only by trying out a system of performance-related pay in the public service. I suggest that the time has come to do just that: to see whether it works in the public service, and if so how it works, on a basis which enables us to discontinue the system if experiments suggest that after all it has no place in public service pay, at least at levels which the taxpayer can afford.



4. The case for testing a system of performance-related pay is strengthened by the sharp diminution of promotion opportunities which is the consequence of our reductions in the size of the Civil Service. About two-thirds of the Civil Service are paid on fixed rates or are at the maximum of incremental pay scales and have no current possibility of improving personal rewards other than through the general annual pay increases. The possibility of receiving additional pay for good performance could provide additional incentives to such people. Nor will it only provide recognition for good performance by individuals based as far as possible on objective performance criteria; it will also improve management by obliging managers consciously to assess, and to be prepared to comment upon, the performance of those for whom they are responsible.

MEGAW

5. Colleagues will recall that the Megaw Report envisaged a two-pronged approach

- a. Performance-related pay ranges in place of rates or scales for staff at Grade 3 (Under Secretary) down to Principal level.
- b. Performance-related bonuses for non-industrial staff at Senior Executive Officer and below.

#### BASIC CONSIDERATIONS

6. In coming to a decision on these matters we need to bear four considerations particularly in mind -

- a. Cost: the perceived cost of a fully-fledged merit or performance-based pay system is bound to be high. Private sector experience points to a general range of perhaps 2-5 per cent of the pay bill. Improved performance should produce offsetting savings, but these are, in the nature of things, exceedingly difficult to quantify.

All that can be said with certainty is that many other employers have had sufficient faith in the value of personal incentives to introduce performance-related pay in their own organisations. Most of them would agree that their decisions to introduce performance-related pay were acts of faith rather than of precise calculation; and a number would express doubts about whether they had actually obtained value for money.

- b. Motivation: the objective of introducing performance-related pay is to improve the overall effectiveness of the organisation. If the systems or methods chosen do not have this effect - if, for instance they demotivate more staff than they motivate - it is clearly better not to introduce



them at all. Moreover if we start on this road, however tentatively, we need to be clear from the outset that we are ready to follow through the logic of our actions. Thus if the limited experiments I am suggesting in this paper show promise we shall be expected to go forward - which would imply finding significant sums of money in future to finance more widespread systems.

Acceptability: a key feature in the motivational effect of any new system will be its acceptability to staff. I say "staff" deliberately because, although we shall need to consult the unions, they are unlikely to oppose merit or performance-related pay in principle. Acceptability to staff will be determined by a number of factors -

i. Staff will need to be reassured that the systems are not merely devices to take money from the generality to give to the favoured few; in my judgment this means that, when a system is introduced for the first time, we should not be thought to be financing it wholly from funds that would otherwise have been available for general pay increases.

ii. They will want to be satisfied that the systems and criteria we propose are "fair": in part this is a question of mechanisms (though we do not want to be too elaborate); in part a question of staff experience of the new arrangements in action; but above all a question of avoiding any taint of favouritism. It will be particularly important that the distribution of awards should be, and seen to be, free from political (including Ministerial) influences.

d. Method: the private sector uses a wide range of different systems for distributing merit and performance rewards. The commonest are merit progression through incremental scales; merit additional to incremental scales; and bonuses of various kinds. Private firms often use a mixture of these techniques as a means of achieving maximum management flexibility to differentiate the pay of individuals within a structured system. In our case the sheer size and complexity of the Civil Service means that we shall need to start with simple mechanisms in order to gain experience of what will be a major task of internal administration.

#### PROPOSALS

7. I have discussed these matters with the Chancellor of the Exchequer, and we are both agreed that it would be wrong to seek to move, in one step, to a fully-fledged merit or performance pay system. Not only would the cost be high and the return uncertain but a great deal of



preparatory work would be needed both to choose the most appropriate methods and to set up the necessary administrative machinery. Moreover, once launched, a full-scale system would be hard to abandon. Our joint view therefore is that, if we are to move at all, we should do so by relatively small-scale experiments which would enable us to test systems and come to a subjective view on effectiveness.

8. If colleagues agree that we should now enter into experiments the Chancellor of the Exchequer and I are both agreed that there should be an explicit time limit of, say, three years after which we would review the position and decide whether to press ahead with more permanent arrangements or abandon the idea altogether.

9. A decision to proceed by means of time limited experiments simplifies the choice of method as between the flexible use of pay scales and the systems of annual (or biennial) bonuses. Only the latter can be readily withdrawn and we recommend that the initial experiments should be confined to bonus systems and that the award of bonuses to individuals should be on a confidential basis.

10. The need to minimise cost also bears decisively on the populations of civil servants we can accommodate within the bonus experiment. We are both agreed that a credible bonus system cannot be achieved by spending less than 1 per cent of the pay bill of those to whom the bonuses are available (so that for example 25 per cent of the staff concerned could receive a bonus of 4 per cent of pay). The choice of the populations to be covered is more difficult. We are both agreed that the experiments ought to embrace at least the total populations of the Civil Service grades from Principal (and equivalents) to Grade 3 (Under Secretary). Together these grades comprise some 20,000 staff - about 3 per cent of the non-industrial Civil Service.

11. Our reasons for this judgment are first that the task although substantial is more manageable and the results more readily assessed at these levels; second that these are the key grades on whom we rely to carry through our plans to modernise and improve the performance of the Civil Service; and third because we shall need to demonstrate to the public that the incentives and disciplines of performance-related pay apply at senior levels. The Chancellor of the Exchequer is prepared to agree that a gross amount of £4 million per annum (equivalent to about 1 per cent of the relevant pay bill) might be expended on an agreed programme of merit bonuses for these staff.

12. It will be important both for the success and for the acceptability of this scheme that it should not seem as if we are prepared to give more money to the better paid, but not to contemplate performance-related pay arrangements for the lower paid as well; and that the introduction of performance-related bonuses for some staff should not be thought to be financed at the expense of their colleagues. The Chancellor of the Exchequer is therefore prepared to agree that -



- a. When we announce this scheme, we should make it clear that we are prepared to consider, and to enter into discussions with the Civil Service trade unions about, the possibility of conducting further merit bonus experiments at more junior levels. We would do so without commitment as to method, timing or finance, but would invite a genuine dialogue on the possibilities. Any schemes emerging from these discussions would be judged on their merits and in the light of experience with the initial scheme. If approved, they would be introduced as early as practicable in the experimental period (which would mean in practice not before 1986-87).
- b. The experimental scheme now proposed should not be required to be, nor be described as being, financed within the existing overall provisions for Civil Service pay.

## CONCLUSIONS

13. I invite my colleagues to agree that -

- a. We should introduce an experimental programme of confidential merit bonuses for non-industrial civil servants in the ranks from Principal (and equivalents) to Under Secretary; starting on 1 April 1985; limited to three years at a cost of £4 million a year; and on the express understanding that at the end of that period the value of the schemes will be reviewed and there is no present commitment to continuing with merit or performance related pay arrangements when the experiments have run their course.
- b. In announcing our decision on merit bonuses at senior level we should indicate that we are prepared to consider, and enter into discussions with the Civil Service unions about, the possibilities of conducting further merit bonus experiments at more junior levels. Discussions on such further experiments would be entered into without commitment as to method, timing or finance, but on the understanding that any such schemes, identified and approved, would be introduced as early as practicable.
- c. The experimental scheme now proposed should not be required to be, nor be described as being, financed within the existing overall provisions for Civil Service pay.
- d. Officials of the Cabinet Office (Management and Personnel Office) and the Treasury, in consultation with Departments, should prepare detailed proposals, in the light of our decisions, for consideration and approval by the Ministers concerned.



e. The Head of the Home Civil Service should be instructed to arrange for the effectiveness of the schemes to be audited so that the Cabinet can, in due course, consider whether to introduce definitive schemes of performance-related, or merit, pay and, if so, what form these schemes should take.

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Cabinet Office (Management and Personnel Office)

24 July 1984