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15 May 1984

Lord Gowrie
Minister of State
Management and Personnel Office
Great George Street
LONDON SW1P 3AL

John Gower

BF // CF had Gowrie will now put forward a revised draft.

Dub 17/5

PERFORMANCE RELATED PAY

You wrote to me on 8 May enclosing a draft Cabinet paper which proposes the introduction of Performance Related Pay, on an experimental basis, in the Civil Service.

I am broadly content with the thrust of the paper, and am particularly glad that you support the idea of performance related bonuses for staff from Under Secretary to Principal levels (as well as lower down). As you know, I am strongly in favour of bonuses (as opposed to performance scales) both on financial and management grounds.

However, I find the arguments for introducing a new "intermediate" class of Permanent Secretaries unconvincing and I doubt whether it will find much support among colleagues. I would therefore suggest that you drop the references to job weighting from your paper, particularly as here we are not really concerned with merit pay at all.

I also have a few small points on the text. First, two different dates are suggested for the introduction of the scheme - in paragraphs 13 and 21(1). I think the paragraph 13 timing is more realistic. Second, paragraph 21(4) discusses the introduction of performance bonuses for grades up to and including Senior Executive Officers from 1 April 1985, while paragraph 19 seeks no more than a decision in principle that at these levels performance bonuses would be appropriate. I believe it is paragraph 19 which strikes the right note; we cannot be committed at this stage to pressing on below Principal level from 1 April 1985. Third, I think the wording towards the end of paragraph 8 should be changed to make it absolutely clear that the bonuses, or "increments", awarded for merit would be paid for only one year at a time.

Finally, there is the question of timing. I think we should ensure that we have settled the current difficult pay negotiations with the non-industrial Civil Service before we make any announcement about merit pay. We also need to watch the timing in relation to announcements on the Review Body Reports.

A copy of this letter goes to the Prime Minister.

John Gower *Nigel Lawson*

NIGEL LAWSON

Civil Service P174

Pay & Pensions



76 FINE 1984



CABINET OFFICE

c. No
Asst Chancellor

From the Minister of State

Lord Gowrie

MANAGEMENT AND PERSONNEL OFFICE

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Telephone 01-233 8610

The Rt Hon Nigel Lawson MP
 Chancellor of the Exchequer
 HM Treasury
 Parliament Street
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8 May 1984

Dear Nigel,

PERFORMANCE-RELATED PAY

Officials have now produced a revised draft Cabinet Paper reflecting the comments made in our earlier discussion, ... and I attach the result herewith.

While the draft sets out as alternatives pay ranges and performance bonuses at Under Secretary to Principal level, it recommends in favour of performance bonuses at these levels, as was envisaged at our earlier meeting. I have, however, left the merit pay range alternative in, since there are those (including, I understand, Sir Robin Ibbs) who think that it would be on balance the better alternative at these levels.

I am copying this letter and enclosure to the Prime Minister.

*Lawson,
 t/g*

LORD GOWRIE

DRAFT

CABINET

LINKING PAY AND PERFORMANCE

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 to the Civil Service. We invited the inquiry into Civil Service pay (the Megaw Committee) to make recommendations on this subject and they did so in the summer of 1982. Since then we have committed ourselves on various occasions and in various documents 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 merit pay for the Civil Service. This paper proposes an experimental and evolutionary approach which will enable us to gather practical experience on which to build for the future.

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 and on the dispersion outwards and downwards of financial responsibility and a sense of that responsibility. We have already taken a number of important steps, including the Financial

Management Initiative (FMI) and the introduction of a programme of reform of personnel work. We need to support this programme of change by encouraging good performance and by improving motivation in the Civil Service to accept this change of style and make it effective. This implies a system of rewards for especially good performance and penalties for unsatisfactory performance. I am looking separately at the disciplines and penalties for poor performance. This paper is concerned with rewards..

3. Hitherto the main incentive to good performance in the Civil Service has been the prospect of promotion to a higher grade. With the sharp diminution of promotion opportunities, which is the inevitable consequence of our reductions in the size of the Service, particularly at the higher grades, this no longer provides a sufficient incentive. About two-thirds of the Civil Service are now paid at the maximum of their pay-scales and have no current possibility of improving personal rewards other than through the general annual pay increases. This strengthens the case for the introduction of some form of performance-related pay system.

4. The Megaw Report envisaged a three-pronged approach comprising:

- a. performance-related pay ranges in place of rates or scales for staff at Grade 3 (Under Secretary) down to Principal level;

b. a closer matching of pay to the job weight of individual posts at Permanent and Deputy Secretary levels;

c. performance bonuses for non-industrial staff at Senior Executive Officer (SEO) and below.

5. Performance-related pay should, if it is to be introduced at all, be available in one form or another at all levels in the Civil Service. It will not be possible to introduce a fully-fledged comprehensive scheme in short order. We have to proceed by stages; and we should concentrate initially on the highest levels of the Civil Service, both in order to demonstrate that the incentives and disciplines of performance-related pay apply at these, as well as at lower, levels, and in order to motivate the senior managers on whom the speed of the drive for efficiency especially depends. As Megaw recognised, there would be difficulty in introducing a merit scheme at Grade 1 (Permanent Secretary) or Grade 2 (Deputy Secretary) level without involving Ministers directly in setting the pay of individual officials; something I take it we should want in principle to avoid. Hence I propose, following Megaw, to start at Grade 3 (Under Secretary) level. But we should consider the Megaw proposal for job weighting at higher levels.

6. For those in the rank of SEO and below the Chancellor of the Exchequer and I agree that in principle the system to be adopted is one of annual performance bonuses. But we cannot introduce such a scheme at once, nor should we now endorse it save in the most general terms, first because we shall need to discuss it with the Civil Service trade unions, and second because the cost could be considerable; 1 per cent of the pay bill (and most concerns seem to devote about this amount to performance-related pay) is about £45 million per annum for the non-industrial Civil Service. Before making any promises the Treasury would want to examine how this could be funded and in particular how the gross cost could be reduced, eg through holding back on the general pay increase.

7. But we could more quickly introduce performance-related pay at higher levels (Under Secretary to Principal) where the cost is clearly less and discussions with unions might be easier. There are two possible approaches at these levels. We could adopt a system of annual (or half-yearly) bonuses; or we could adopt a system of performance-related pay ranges, as recommended by Megaw.

8. The arguments in favour of a merit pay range scheme would be:

- a. that is what Megaw recommended, and what is widely used at comparable levels in private sector

industry, though there are signs that some concerns using scales are moving over into bonuses or something much more akin to them;

b. it would give us experience of the advantages and disadvantages of such a system in the context of the public service;

c. at these levels, where it would be particularly important to motivate people for sustained good performance, a scheme which provided for continued payment (subject to continued good performance) might be more likely to motivate those concerned in the way we need;

d. it would, once established, be significantly less demanding of senior management time - with the decisions conforming to the principles of management by exception rather than involving a full review of all eligible postholders each year.

Increments payable for merit would be reviewed each year, and it would be clearly understood that they would be reduced or withdrawn if good performance was not sustained. They would be paid as part of the monthly salary payments. They would qualify for pension purposes; but this would not be likely to add significantly to pension costs, since most of those qualifying for merit pay at these levels could be expected to go on to higher levels before retirement.

9. The advantages of a system of annual performance bonuses would be that:

- a. the bonuses would not qualify for pension purposes;
- b. the award of a bonus to an individual in one year would not imply any commitment to the payment of a bonus to that individual the following year; there would be no need to preclude the payment of bonuses for several years running, but they would have to be earned afresh each year;
- c. because they would be payable in a lump sum once (or twice) a year, they would be clearly seen by the recipients as different from regular pay;
- d. the total paid out under a bonus scheme is likely to be more easily controlled than under a scale scheme; more capable of being accurately directed to those whom it is currently wished to reward; and more capable of being directly related to the achievement of defined performance targets under the FMI;
- e. a bonus scheme is more easily stood down than a system of scale increments, which makes it more appropriate for the sort of experiments which we have in mind.

10. In either case it would be necessary to work out criteria for eligibility, and arrangements for deciding who of those eligible should receive merit payments.

We want the system to reinforce the FMI, and one of the criteria is therefore the achievement of the objectives and targets defined in the management systems being developed in the FMI. At these levels, however, objective measures of performance are more difficult - often impossible - to establish, and judgment of merit is mainly subjective. This throws an additional burden on those who have to allocate merit payments, but it also obliges them to practise the exercise of managerial judgment.

11. Having discussed this with the Prime Minister and the Chancellor of the Exchequer, I recommend that we go for a system of performance bonuses at these levels. The proposals for which I seek Cabinet approval are therefore as follows:

PERFORMANCE-RELATED PAY FOR GRADES FROM UNDER SECRETARY TO PRINCIPALS

12. We should institute a system of annual bonus payments (which could if we wished be payable half-yearly), expressed either as a flat rate or as a percentage of salary. Payments would be awardable according to individual performance. Entitlement to merit pay bonuses would be reviewable annually. For Under Secretaries entitlement would be judged by the Head of the Department, in consultation with Deputy Secretaries; for lower grades similar arrangements would be worked out. The number of postholders who could be in receipt of performance-related

pay bonuses or increments would be limited to, say, a maximum of 25 per cent; and the total cost of the merit payments in any grade would also be subject to a limit related to the total salary costs for that grade. The scheme would be limited to the non-industrial Civil Service, and would not extend to fringe bodies.

13. If the Cabinet agrees, officials of the Treasury and the Cabinet Office will be instructed to work out detailed arrangements for a system of performance bonuses at these levels, with a view to an early announcement. The appropriate unions will need to be consulted before an announcement is made. It should be possible to introduce a scheme for Grade 3 (Under Secretaries) from 1 October 1984. It may well be necessary to defer the introduction of the scheme at Assistant Secretary level and below a little later - say, to 1 April 1985 - purely for administrative reasons: for the larger Departments the arrangements for choosing those who are to receive merit payments may at those levels take rather longer to put into place. If that proved to be the case, it would be positively advantageous to make an early start with Under Secretaries: it would provide valuable learning experience for the later extension to the lower grades.

14. 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 payable

in the Under Secretary/Principal (and equivalent) grades; to the extent that any grades are not brought in, or brought in later, this amount would be scaled down as appropriate. He would be content for an agreed merit bonus scheme to run for three years on the explicit understanding that there is no commitment to continue the experiment after that. Each 12 month period from the start of the scheme should be individually cash limited at £4 million at maximum, scaled down as appropriate to the extent that grades are not brought in immediately. So far as any expenditure which falls in 1984-85 goes, Departments should do their best to absorb this; in cases where it is claimed the settlement could not be absorbed or offset within existing cash limits the position would be looked at urgently on merits; any special addition to cash limits in 1984-85 on this account would be charged to the Reserve. For later years the necessary funding will be taken into account in the funding of the Civil Service pay settlement generally.

JOB WEIGHTING FOR GRADES 1 AND 2

15. There are at present three "grades" of Permanent Secretary:

Grade 0	Secretary of the Cabinet)	
	Permanent Secretary to the Treasury)	
	Permanent Under Secretary of State)	£48,000
	Foreign and Commonwealth Office)	
Grade 1	Permanent Secretaries in charge of Departments)	£42,750
Grade 1A	Other (or "Second") Permanent Secretaries)	£39,500

This lumps together all Permanent Secretaries in charge of Departments, whatever the weight of their policy and management responsibilities. There is clearly a large difference between the job weight of (for example) the Permanent Secretary to the Ministry of Defence, with responsibility for the management of more than 200,000 staff, and that of (for example) the Permanent Secretary to the Department of Energy, with about 1,200 staff, and a correspondingly clear case for some difference between the job weighting and remuneration. On the other hand, it is questionable whether we should look for too complicated or sophisticated a set of weightings; apart from everything else, that would be taken to imply a pecking order of Departments which could fetter the Prime Minister's discretion in recommending Ministerial appointments.

16. If the Cabinet decides in principle in favour of job weighting for Permanent Secretaries, I recommend that in this experimental stage we should confine ourselves to two levels at Grade 1, reflecting a broad assessment of differences in

weight of a combination of policy and management responsibilities:

Grade 1(1) Permanent Secretaries to the Ministry of
Defence
Home Office
Scottish Office
Department of
Health and
Social Security

Grade 1(2) Other Permanent Secretaries in charge of
Departments.

The Top Salaries Review Body could be asked to recommend appropriate salary rates, to come into effect from 1 October 1984.

17. At Grade 2 (Deputy Secretary) level, the weight of the load tends to be reflected in the number of posts at the level in the Department: the Ministry of Defence (for example) has 17 Grade 2 posts, while the Department of Energy has only 3. I am not convinced that job weighting of individual posts varies so markedly as to justify differences of remuneration. I recommend that this should be subject to further examination.

PERFORMANCE BONUS SCHEME FOR GRADES UP TO SENIOR EXECUTIVE OFFICER

18. The Megaw Report recommended that at grade levels up to that of SEO a limited number of non-pensionable bonuses should be available each year on evidence of consistently outstanding performance. I recommend that we should now accept this recommendation in principle, as a basis for a Service-wide experiment, and announce that we propose to discuss with the unions the forms which a system of non-pensionable performance bonuses might take, with a view to introducing a scheme or schemes on an experimental basis from 1 April 1985 for three years in the first instance. This will have the advantage of

demonstrating our intention to introduce performance-related pay arrangements right through the Civil Service, not just at higher levels; and will give us the opportunity of discovering whether arrangements can be devised which are reasonably acceptable to the staff (and therefore likely to achieve our objectives) and can be introduced at a reasonable cost in money and administrative resources.

19. Performance bonuses could be expressed as a proportion of salary or as absolute amounts. These amounts, and the numbers of staff eligible to receive them, would depend on how much we were prepared to afford. There would have to be criteria for eligibility, and arrangements for deciding who of those eligible should receive bonuses. All these questions will require further detailed work and discussion with the Civil Service unions. At this stage I seek no more than a decision in principle that at these levels performance bonuses would be appropriate, and that we should discuss such a system with the Civil Service unions with a view to possible introduction on an experimental basis from 1 April 1985 or as soon as possible thereafter, subject to the outcome of discussions that I shall be having with the Chancellor of the Exchequer as to whether money can be found for such an advance and if so how much.

CONCLUSIONS AND RECOMMENDATIONS

20. We need to act now to reinforce the pressure for an improved style and greater professionalism of management in the Civil Service, and for better value for money, by introducing arrangements to link pay to performance.

21. I invite the Cabinet to agree:

(1) to the introduction of a performance-related system for the grades from Under Secretary to Principal inclusive from 1 October 1984;

(2) to decide whether that scheme should be based on a system of performance bonuses or on a system of performance-related pay ranges (paragraphs 12 to 14);

(3) to the introduction of a system of job weighting for Permanent Secretaries in charge of Departments (paragraphs 15 to 17); and

(4) that officials should enter into discussions with the unions with a view to the introduction of a system of performance bonuses for grades up to and including Senior Executive Officers from 1 April 1985 (paragraphs 18 and 19).

22. If the Cabinet decide accordingly, I recommend that the schemes should all be regarded as experimental and as a single package. This will enable us more readily to counter criticisms from the media and elsewhere that, despite the managerial advantages, we are favouring senior civil servants. I further recommend that the Head of the Home Civil Service should be instructed to audit their effectiveness and to report further so that the Cabinet can in due course consider whether to introduce definitive schemes of performance-related pay and, if so, what form these schemes should take.

29 Jul 1984

