



Prime Minister (11)

There are unresolved differences between the Chancellor and Lord Gove on merit pay. Agree to discuss with them, plus Sir Robin Ibbotson, before a paper is circulated to the Cabinet?

PRIME MINISTER

PERFORMANCE-RELATED PAY

You held a meeting on 16 March to consider the introduction of performance-related pay, on an experimental basis, into the Civil Service and the Chancellor of the Exchequer and I were invited to prepare a paper for Cabinet.

Sub  
16/3

We have done so and I now attach an agreed draft which sets out the position we have reached. Although we have a common view on the substance of the issues, we have been unable to agree on two important points. These are the coverage of the experimental bonus schemes and the manner in which they are to be financed. The Chancellor wants the experiments restricted to the senior ranks from Principal to Under Secretary whereas I believe it important for both practical and presentational reasons to spread the experiments more widely into junior levels (if necessary at the expense of dropping Principals from the senior experiment). The Chancellor also wishes to limit expenditure to £4 million to be found as far as possible from within existing cash allocations. I believe that, while £4 million is adequate for experiments at senior level, we ought to be prepared to contemplate somewhat higher expenditures - at least in terms of forward planning - as we identify worthwhile experiments lower down the line and as results begin to come through. This would ease the task of persuading staff to accept the introduction of the experiments. I believe that only clear signals as to the extent of the Government's interest will make the experiments productive and worth pursuing.

There are two other matters to which I should also draw your attention. The first of these relates to proposals, which are now at an advanced stage of development, for extending unified grading to Principals and their scientific, professional and technical counterparts. This would be a very important major reform of Civil Service structures and, because unifying the grades inevitably means unifying pay, it would open up possibilities of introducing a more permanent form of merit pay at this level. We are still in discussion with the Treasury and other Departments about this but I hope to be able to come forward to you with a set of proposals on unified grading at Principal level in the next 10 days or so. If it proves possible to devise suitable arrangements (including an element of merit pay) at this level it should be significantly easier to take decisions about the details of the merit bonus proposals.



CONFIDENTIAL

You will in any case I think wish to discuss the merit bonus proposals, and the fundamental issues involved, with us and with Sir Robin Ibbs. And a meeting for this purpose would need to take place soon if we are to take the question to Cabinet before the recess. I hope that we will also be able to make sufficient progress on unified grading for this to be taken into account at the Cabinet meeting.

The second related matter is the Megaw proposal to adjust the pay of Permanent Secretaries to reflect more closely the relative weight of the jobs they carry. We have now left this out of the paper because it is not strictly a merit issue. It would nevertheless be convenient if the question of whether to make a reference to TSRB on this Megaw recommendation could also be settled soon so that Lord Plowden and his colleagues can advise us in the course of their current review. If you agree, I will write you a letter, circulated to Cabinet colleagues, which could provide a peg for a decision on the point.

Agree?

Doubt

16/7

I am copying this minute to the Chancellor of the Exchequer, Sir Robin Ibbs and Sir Robert Armstrong.

gg

LORD GOWRIE

13 July 1984

CONFIDENTIAL





10 DOWNING STREET

*From the Private Secretary*

17 July 1984

PERFORMANCE RELATED PAY

The Prime Minister was grateful for Lord Gowrie's minute of 13 July to which was attached a draft Cabinet paper on performance related pay.

The Prime Minister agrees that the issues which remain unresolved between Lord Gowrie and the Chancellor should be discussed before any paper is circulated to members of the Cabinet. We will be in touch with both your offices, and with Sir Robin Ibbs and Sir Robert Armstrong, to arrange a time.

The Prime Minister has noted that Lord Gowrie will be putting forward proposals shortly on unified grading at Principal level. She also agrees that he should now circulate a letter on the question of job weighting for Permanent Secretaries.

I am sending copies of this letter to Margaret O'Mara (HM Treasury) and to Sir Robin Ibbs and Sir Robert Armstrong.

David Barclay

Mrs Mary Brown  
Lord Gowrie's Office



## CONFIDENTIAL

## PERFORMANCE-RELATED PAY: DRAFT CABINET PAPER

1. 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 (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 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



# CONFIDENTIAL

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

CONFIDENTIAL<sup>2</sup>



# CONFIDENTIAL

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 (SEO) 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.



# CONFIDENTIAL

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.

c. 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 likely to oppose

4  
CONFIDENTIAL



# CONFIDENTIAL

merit or performance-related pay in principle.

Acceptability to staff will be determined by a number of factors;

*There must surely be some element of re-distribution*

*2ms  
16/7*

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 judgement 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



# CONFIDENTIAL

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 chose 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 and I are both agreed that there should be an explicit time limit of, say, three years after



# CONFIDENTIAL

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 one 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 four 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 three per cent of the non-industrial civil service.



# CONFIDENTIAL

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 one per cent of the relevant pay bill) might be expended on an agreed programme of merit bonuses for these staff.

12. The Chancellor and I are not fully agreed about whether experiments at the higher levels should be matched by other experiments lower down the hierarchy. The Chancellor does not challenge the usefulness of such experiments - which might enable a variety of bonus techniques to be tested - but is concerned over financing. The problem is that if, as the Chancellor would prefer, the finance available for experiments at all levels were limited to £4 million per annum in total we would be forced either:

- a. to confine the initial scheme to the senior group and make it clear that we are postponing the introduction of experiments below Principal level at least for the time being;



# CONFIDENTIAL

b. to cut back the coverage of the experiments in the Principal to Grade 3 (Under Secretary) groups, eg by omitting the Principals (around 14,000 with equivalents) with the funds released being expended on experiments at lower levels.

13. My view is that either course would restrict the experiments in unacceptable ways. If we confine the experiments solely to senior grades we open ourselves to the charge of favouring the better paid few at the expense of the lower paid many - and staff reaction could well be adverse. If on the other hand we cut back the senior grades experiment by omitting the Principals in order to release small (and possibly inadequate) sums to finance experiments lower down, we forego the opportunity of providing some relief for the very real management problems we face at Principal level. As colleagues know, we have quite deliberately loaded more responsibility on Principals and their equivalents; their promotion prospects have been reduced; there is difficulty in finding or recruiting adequate numbers of competent people to the grade; and some of the best of them are leaving the service. My personal view is that bonuses alone will not solve these problems; but they might help at the margins, and I would be reluctant to forego that possibility.



# CONFIDENTIAL

## Finance

14. In short, the issues here turn on finance. Can we afford to go ahead at all? If so can we get a credible package for £4 million? And if we need to spend more, how much further can we go and how can we find the money? The Chancellor and I are agreed that, if at all possible, we should make an early start on these experiments. The Chancellor feels however that the present public expenditure position does not justify our committing ourselves further now than the £4 million to be expended at the higher grades; he is prepared for discussions to open with the unions about the possible extension of the experiments down the line in due course but without any specific commitment whether and when more money might be expended. For the reasons set out in paragraph 12 above, however, I do not think this is an acceptable way to proceed; nor would the alternative of cutting back on the coverage at the higher grades be satisfactory. If we are to tackle the job at all I believe that we need to enter into discussions with the unions about the lower grades with the knowledge that some money can be found. I suggest a limit, subject of course to specific authorisation in each case, of up to £6 million for this purpose.

15. The Chancellor is also concerned, rightly, that the basis on which experiments are financed (as opposed to authorised) should be clear at the outset. His view is that the cost of the merit bonus experiments, within the agreed ceilings, should be taken into account in the funding of the general Civil



Service pay settlements for 1985-86 and later years.

Departments would thus be expected in the first place to find the cost of merit bonuses, along with the cost of the general Civil Service pay settlement over and above the provision made for planning purposes, from their own resources; and only very exceptionally to bid for additional, money. I on the other hand can see considerable merit in setting aside specific extra sums of money for experiments not least because 'new' money will greatly ease the task of ensuring staff acceptance of the proposals. But in present circumstances, and given our recent decisions on public expenditure, the Chancellor thinks that it would be wrong to allow specific additions to programmes on this score. He considers, in any event, that any such proposals should be considered in the Public Expenditure Survey alongside other additional bids by colleagues.

Recommendations

16. In the light of the foregoing considerations my recommendations to colleagues are -

- i. that we should decide now whether or not we want to introduce an experimental programme of confidential merit bonuses for selected groups of non-industrial civil servants starting - probably on a phased basis - on 1 April 1985; limited to three years in each case; and on the express understanding that there is no present commitment to continuing with merit or performance-related arrangements when the experiments have run their course.
- ii. if we favour experiments, to decide whether we want them to cover -



# CONFIDENTIAL

a. civil servants from Grade 3 (Under Secretary) to Principal and equivalent grades only at a maximum annual gross cost of £4 million;

b. civil servants at Under Secretary to Assistant Secretary levels (Grades 3, 4 and 5) plus selected groups at lower levels at an annual maximum gross cost of £4 million.

or  
c. this group plus selected groups at lower levels at a maximum annual gross cost of (£10) million;

iii. to consider whether the experiments should be funded in the same way as the general Civil Service pay settlements for the years in question on the lines set out in paragraph 14; or whether they should be funded by specific additions to existing programmes;

iv. to instruct officials of the Cabinet Office (MPO) and the Treasury, in consultation with Departments, to prepare detailed proposals in the light of our decision for consideration by the Ministers concerned;

v. to instruct officials to prepare a draft announcement of our broad intentions for use at a date to be determined;

vi. once the announcement has been made, to authorise

CONFIDENTIAL



CONFIDENTIAL

officials to enter into discussion with the relevant civil service trade unions with a view to obtaining their acquiescence, if not consent, to the detailed arrangements; and, if our decision is not to extend the initial experiments below Principal level, to begin a without commitment exploration with them of the possible modalities of such future extension for the initial experiment;

vii. if we decide not to extend the initial experiment below Principal level, to authorise officials to explore with the unions, on a non-committal basis, the possibility of extending performance-related pay down the line.

viii. to instruct the Head of the Home Civil Service 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.

Cabinet Office (Management and Personnel Office)

July 1984

CONFIDENTIAL



Civil Service : pay & pensions Pt 14