

Chair
Cabinet Government Administration and Expenditure Review Committee

PUBLIC SERVICE CHIEF EXECUTIVE REMUNERATION

Proposal

- 1 The purpose of this paper is to inform Cabinet of the State Services Commissioner's (the Commissioner's) intention to remove performance pay from employment agreements in the Public Service, consistent with the Government Expectations on Employment Relations in the State Sector.
- 2 The Cabinet Government Administration and Expenditure Review Committee should also note that the Commissioner is proposing changes to the annual disclosure of senior executive remuneration in the Senior Pay Report, subject to future Cabinet agreement.
- 3 The Commissioner has discussed his proposals with me and I support the changes he is making.

Public Service chief executive remuneration

- 4 The Commissioner is the employer of Public Service chief executives and determines their remuneration. Remuneration for other senior executives, for example the Solicitor-General, the Commissioner of Police, and the Chief of Defence Force, is set by the Remuneration Authority. The Boards of Crown entities set the remuneration for their chief executives either with the Commissioner's consent or in consultation with him.
- 5 Currently, Public Service chief executive remuneration packages include an "at risk" component (10% of base salary) and the potential to receive a discretionary payment of up to 15% for exceptional performance. This remuneration approach was introduced as part of chief executives' terms and conditions in January 2014.
- 6 Since his appointment in July 2016, the Commissioner has been consistent in expressing concern about the sustainability of chief executive pay levels and their trajectory, and in questioning the effectiveness of performance pay.
- 7 In relation to the issue of chief executive pay levels themselves, the Commissioner directed that a range of pay settings be dialled back to reduce the trajectory of chief executive pay levels, particularly at the top end. These included appointing and re-appointing chief executives lower in ranges; conservative mid-term remuneration reviews; reviewing remuneration ranges with a view to continuing the freeze of recent years; and reviewing job sizes at appropriate intervals at the discretion of the Commissioner.
- 8 Alongside this, the Commissioner initiated a review of the performance pay system.
- 9 These actions were noted when the chief executive remuneration disclosure (the Senior Pay Report) was presented to Cabinet in December 2017 (CAB-17-MIN-0539.02). In the introduction to the report the Commissioner said that the "new remuneration settings will recognise and reward motivations other than remuneration and support the delivery of high quality services to New Zealanders".

- 10 These actions have resulted in a flattening of the rate of growth of pay levels at the top end although the full effect is yet to be realised. The Commissioner is now addressing the structure of chief executive remuneration packages including the removal of performance pay components.

Performance pay

- 11 In a context where employees demonstrate high levels of intrinsic motivation, international research shows that individualised performance pay is not an effective incentive for higher performance for complex roles such as these.
- 12 Furthermore, it is counter-productive to achieving the collaborative team-based approach and collective leadership that the Commissioner expects of his senior leaders, which is critical to achieving better (joined-up) outcomes for New Zealanders.
- 13 This approach to unified, joined-up leadership is central to creating a New Zealand Public Service that has citizen-focused outcomes and services at its core.
- 14 It is also consistent with the intent of the proposed New Zealand Public Service Act (the rewrite of the State Sector Act) that is currently underway.
- 15 Under the new remuneration approach, Public Service chief executive remuneration will comprise fixed cash based remuneration only, removing any discretionary performance payments.

Approach to driving performance

- 16 For 2018, a new chief executive performance management framework has been introduced. This comprises four key elements:
- 16.1 Explicit, upfront performance expectations
 - 16.2 Active advice and support from the Commissioner and the State Services Commission
 - 16.3 Real-time feedback and review
- 17 The simplified, cash based remuneration approach proposed in this paper completes the new framework.
- 18 It builds on a reworked approach to the recruitment and development of chief executives, introduced in 2017, and is complemented by the use of other performance improvement tools such as the Performance Improvement Framework Reviews.
- 19 Performance management is no longer summative assessment based, backward looking and shaped by a resource heavy process at financial year-end with chief executives assigned ratings against generic expectations.
- 20 The new approach is more appropriately based on a calendar year, with expectations tailored for each chief executive based on and aligned to the priorities of the Government, and the chief executives' respective areas of accountability as heads of departments and system leaders.
- 21 Real-time feedback is critical to driving performance. This is a foundational component of the new approach, and allows performance discussions, in the most part, to be forward looking.
- 22 The approach to chief executive remuneration that has been in place relies on chief executives being "objectively" rated to determine the level of discretionary payment they will be awarded. This has meant that a large amount of effort goes into managing the assessment process itself in an attempt to make judgements about chief executives' relative performance. Instead, this effort should be focused on driving performance and delivering results.

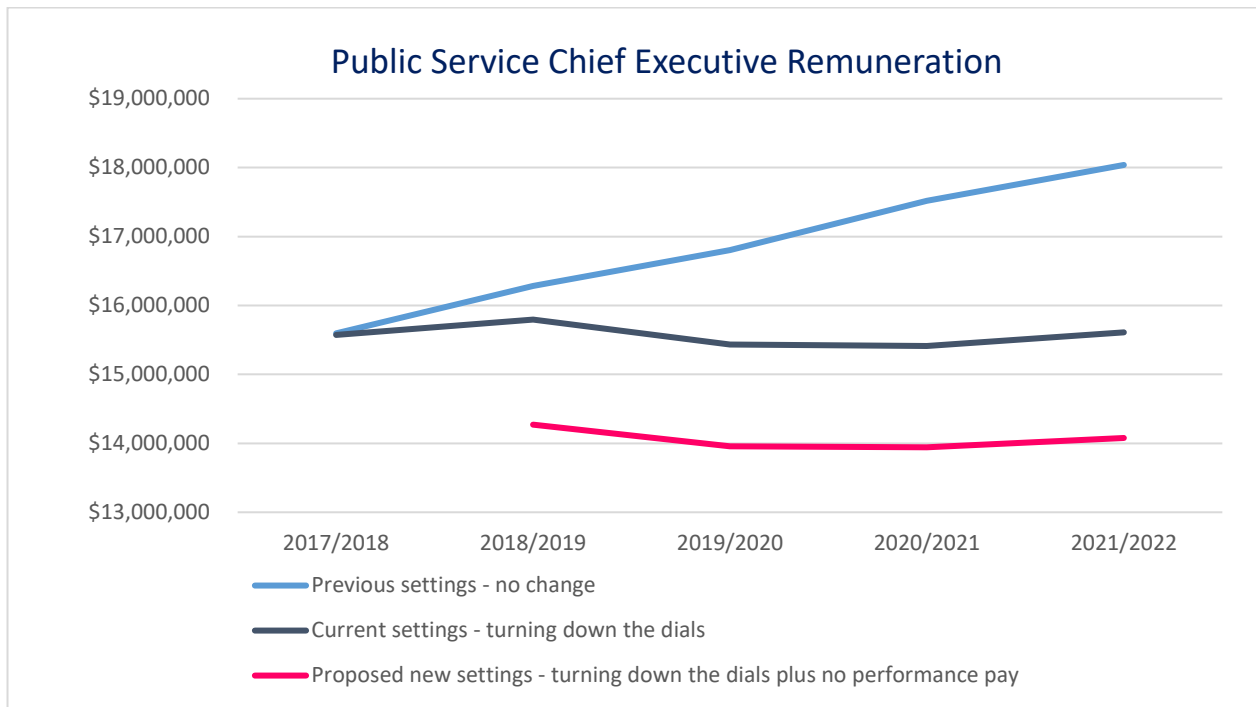
- 23 Restructuring and simplifying remuneration to remove performance pay is the last component of the Commissioner's new approach to managing chief executives' performance in the Public Service.

Implementing the removal of performance pay

- 24 The Commissioner is currently discussing the removal of performance pay with his (chief executive) employees, and following consideration of his proposals by Cabinet, he will write to them offering new contracts, with the intention that revised individual employment agreements (IEAs) will be in place from 1 July 2018.
- 25 The Commissioner does not have the legal authority to mandate these changes and each chief executive must agree to accept a new IEA for the changes to be implemented.
- 26 The Commissioner is confident that the majority of chief executives will move to new IEAs. They understand and accept the rationale for change.
- 27 The Commissioner will also be offering appointment to any vacant roles (including appointments by transfer) only on the basis of the new IEAs. It is anticipated that any old IEAs remaining in place will be able to be transitioned out over a relatively short period.
- 28 The new IEAs will have no earn-back or performance payment provisions. The current earn-back (at-risk) provision will be rolled into the fixed cash based remuneration. Effectively, it is withheld salary and in all but a very small number of cases (one or two a year) has been paid in full, since it was introduced in 2014.
- 29 The potential to receive discretionary performance payments will go. In return, the new IEAs will provide for an annual remuneration review rather than a review once during a three to five-year term; an additional five days' annual leave - the current entitlement of four weeks paid annual holidays is the minimum required by the Holidays Act 2003; and access to some form of income protection insurance. These benefits, which are relatively low cost, are valued by the chief executives.
- 30 Annexed to this paper is a diagram illustrating changes proposed to the remuneration package for an "average" Public Service chief executive. It shows that the potential remuneration available as a result of the removal of performance pay will decrease.
- 31 The extent of change in actual remuneration for each chief executive is dependent on the level of performance payment each chief executive has previously received. These changes will first be reported in the Senior Pay Report for the 2018/19 year.

Impact of changes in remuneration

- 32 The following graph shows the impact of the changes (both the changes to pay settings and the removal of performance pay) to the overall cost of CE remuneration that the Commissioner is taking. It compares the trajectory based on the former policy settings and remuneration structure with the new regime.
- 33 It is clear that the new approach significantly constrains the growth of CE remuneration.



Performance pay in the Public Service

- 34 Around 1,500 people or 3.1% of Public Service employees received performance payments in 2017, with an average payment of \$2,647. Sixty percent of these were made by four departments, (the Ministry of Business, Innovation and Employment, the Ministry of Foreign Affairs and Trade, Land Information New Zealand, and the Department of Internal Affairs), although overall 22 of 29 agencies awarded performance payments.
- 35 In certain circumstances it may be appropriate to recognise exceptional performance in relation to a very specific deliverable with a moderate one-off payment. However, for much the same reasons as those pertaining to chief executives, the Commissioner considers that a contractual entitlement to performance pay is not an appropriate component of general public service remuneration.
- 36 On 5 March 2018, Cabinet agreed *Government Expectations on Employment Relations in the State Sector*. These Expectations make it a priority for core Public Service departments to work toward removing at-risk pay and performance bonuses from pay policies and employment agreements.
- 37 As the employer of their agency's staff, each chief executive has responsibility for employment terms and conditions. However, the Commissioner will encourage and support chief executives to achieve the removal of performance pay over the next two years. He will write to chief executives setting out this expectation and intends to produce guidance to assist a transition to agreements without performance pay, including what might be the acceptable proportion of performance pay to roll into base salary.
- 38 At this point it is not thought necessary to provide additional legislative mechanisms to achieve the outcomes sought. We are, however, considering the need for the ability to set stronger central expectations around employment terms and conditions as part of the work on the New Zealand Public Service Act (the rewrite of the State Sector Act).

Remuneration disclosure

- 39 Each year the Commissioner reports on the pay and cash value of benefits for Public Service and Crown Entity chief executives. The disclosure is based on what a chief executive in the role has actually received in the year rather than what they earned for the given period. The data is, therefore, subject to variation due to the timing of performance payments, the number of fortnights in a year and the like. This makes interpretation difficult and does not always represent what the remuneration for the role actually is.
- 40 Cabinet must agree to significant changes to the reporting regime and its basis. I intend to present a future Cabinet Paper outlining a new accrual based regime that will be more easily understood and relevant, and will continue to meet the disclosure objectives of transparency and accountability in the spending of public moneys.

Communicating these decisions

- 41 Any communication related these changes will be managed by the Commissioner in consultation with my office.

Financial implications

- 42 Expenditure on Public Service chief executive remuneration and employment costs will remain within appropriation.

Human rights

- 43 N/A

Legislative implications

- 44 N/A

Regulatory Impact Analysis

- 45 N/A

Gender implications

- 46 N/A

Disability perspective

- 47 N/A

Recommendations

- 48 It is recommended that Cabinet:

- 1 **Note** that, since his appointment, the State Services Commissioner (the Commissioner) has taken action to address his concerns about chief executive remuneration, including the effectiveness of performance pay.
- 2 **Note** that the Commissioner is taking a new approach to managing the performance of Public Service chief executives, which includes changing the structure of their remuneration.
- 3 **Note** that the Commissioner intends to remove performance pay from chief executive employment agreements from 1 July 2018.
- 4 **Note** that these changes will be reflected in the 2018/19 Senior Pay Report.
- 5 **Note** that I will report back to Cabinet on the changes the Commissioner is intending to make on the format of the Senior Pay Report.

- 6 **Note** that the Commissioner will ensure that the Government's priority, as set out in the Government Expectations on Employment Relations in the State Sector, to remove performance pay in the Public Service, is met.

Authorised for lodgement

Hon Chris Hipkins
Minister of State Services

RELEASED BY SSC UNDER OUR COMMITMENT TO OPEN GOVERNMENT

In-Confidence

NEW REMUNERATION SYSTEM FOR PUBLIC SERVICE CHIEF EXECUTIVES AT 1 JULY 2018

Example - Average Chief Executive

