

Compensation Issues Relating to Expatriate Managers: A Review of Related Literature

Sheikh Abdur Rahim *

Abstract

The present study revealed the problems involved with the preparation of compensation package for the expatriate managers. The study also revealed the measures, which the managers of multinational companies throughout the world can help to reduce the problems while preparing the compensation package for the expatriate managers. Based on the secondary data, the paper argues that preparation of compensation package for the expatriate managers is very much difficult because of environment, nature of the assignment, skills, knowledge, competencies and so on between parent country and host country. The researcher also opens the scope for further research on test and describes the strategic flexibility model as to how MNCs are reacting to the complexities they face in dealing with international compensation.

Keywords: Compensation, Expatriate, Multinational, Allowance, Premium, Manager.

Introduction

For multinational firms, successful management of compensation and benefits requires knowledge of the employment and taxation laws, customs, environment, and employment practices of many foreign countries. Also needed are familiarity with currency fluctuations and the effect of inflation on compensation, and an understanding of why and when special allowances must be supplied and which allowances are necessary in what countries. All of these needs must be fulfilled within the context of shifting political, economic, and social conditions. The level of local knowledge required in many of these areas requires specialized advice; many multinationals retain the services of consulting firms which may offer a broad range of services or provide highly specialized services relevant to HRM in a multinational context.

Because of their high-cost, HR managers spend a great deal of time developing effective compensation and benefit programs for international employees. A survey by the Conference Board found that 38 percent of firms reported an expatriate cost of 4 to 5.6 times, 40 percent reported 6 to 7.5 times, and 16 percent reported 8 to 9.25 times parent country's salary. A recent report in Fortune on doing business in China reported that hiring a local Chinese manager with 15 years of experience would cost less than U.S. \$ 1,80,000; a U.S. expatriate would cost U.S. \$ 6,00,000; an England expatriate would cost U.S. \$ 5, 50,000 with the following compensation package (all figures in U.S. \$):

*Assistant Professor, Faculty of Business and Economics, Daffodil International University

Salary	\$ 2, 50,000
Car & Driver	20,000
Benefits:	
Medical	10,000
Pension	30,000
Housing	1, 50, 000
Flights Home	35,000
R & R	15,000
Education for Children	40,000
Total	\$ 6, 00, 000

Objectives of the Study

The research has been conducted to:

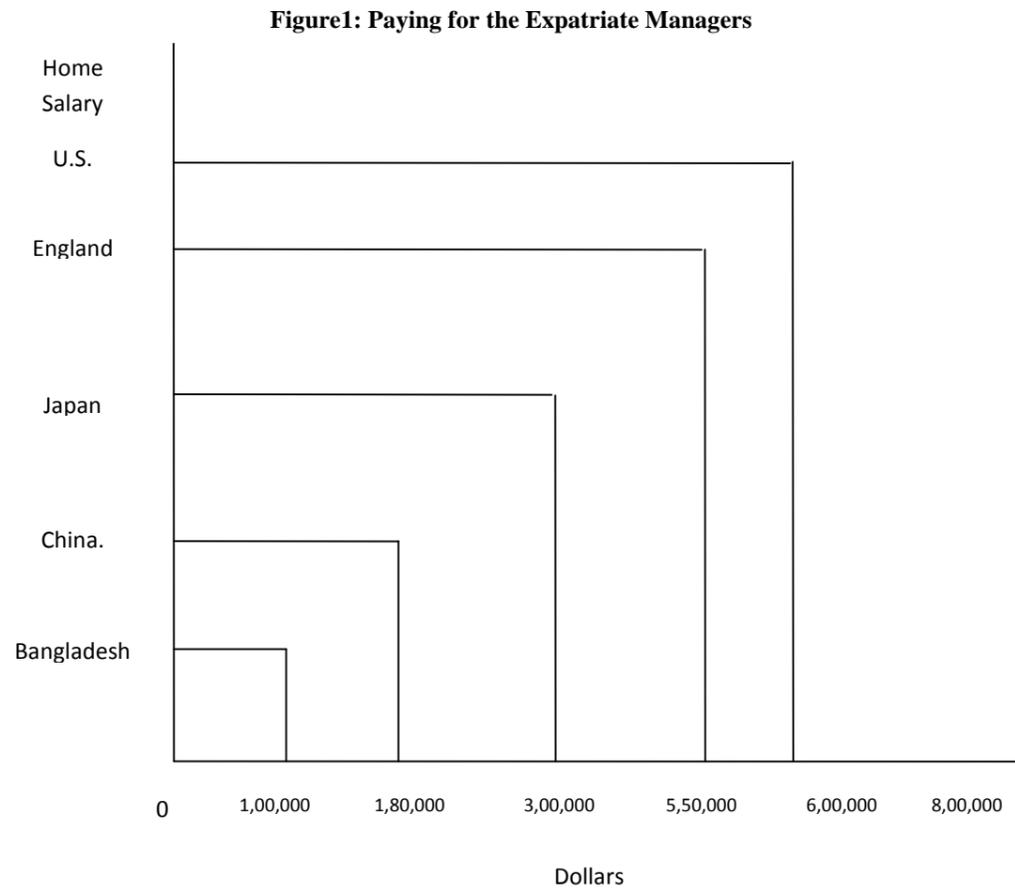
1. explain the key components involved with the preparation of standard compensation packages of expatriate managers;
2. examine the technical aspects and complexities involved with the preparation of expatriate compensation package in an international standard;
3. find out the possible problems of preparing expatriate compensation package by meeting the objectives of the multinational companies and the expatriate managers; and
4. recommend some suggestions to overcoming the problems so that the authority of MNCs can prepare the standard compensation package to fulfill the needs & demands of the companies and the expatriate managers.

Research Methodology

This paper is the result of extensive desk research. The research methods involve (a) collection of relevant literature from various sources such as different books, articles, journals and internet, (b) review of the literature through content analysis, and (c) assimilation and synthesizing of the information to make a coherent whole. For analysis of data, table; chart; graphical representation; Microsoft word and Microsoft excel were used.

Literature Review

International Human Resource Management (IHRM) decisions regarding the use of expatriate managers must take into account the costs of such assignments. Total compensation of expatriate managers often exceeds six to seven times that of home –based salaries and benefits. Extremely costly locations such as China can be even higher. In China, for example, a bilingual HR manager can expect a base salary approaching of \$ 6,00,000, hardship allowances as high as 35 percent of salary, two free houses (one in Hong Kong for week ends and one in China), and chauffeur –driven cars(Lublin and Smith, 2007) . Figure-1 shows data on total compensation packages of U.S., England, China, Japan, Bangladeshi expatriate managers posted in different countries throughout the world.



Source: Tomlinson, Richard, 2008. *You get what you pay for, corporate recruits in China* Find Fortune, April 28, pp. 218-219

Even with such high costs, U.S. companies in particular have poor records of expatriate success when compared with other countries' expatriates. Survey shows that U.S. multinationals often have failure rates for managers in overseas assignments ranging from 10 to 40 percent (Tung, 1988).

Typical reasons for U.S. expatriates failure include the following:

- i) Spouse fails to adapt to local culture or environment.
- ii) Manager fails to adapt to local culture or environment.
- iii) Other problems with the family.
- iv) Personality of the manager.
- v) Excess or difficult responsibilities of international assignment.
- vi) Lack of technical proficiency.
- vii) No motivation for international assignment.

Harvey (1993) said that a firm seeks to satisfy several objectives when developing international compensation policies. **First**, the policy should be consistent with the overall strategy, structure, and business needs of the multinational. **Second**, the policy must work to attract and retain expatriate managers in the areas where the multinational has the greatest needs and opportunities. Thus, the policy must be competitive and recognize factors such as incentive for Foreign Service, tax equalization, and reimbursement for reasonable costs. **Third**, the policy should facilitate the transfer of international employees into most cost effective manner for the firm. **Fourth**, the policy must give due consideration to equity and ease of administration. Harzing (1998) said that the international employee will have a number of objectives that needs to be achieved from the firm's compensation policy. **First**, the employee will expect that the policy offers financial protection in terms of benefits, social security, and living costs in the foreign location. **Second**, the employee will expect that a foreign assignment will offer opportunities for financial advancement through income and/or savings. **Third**, the employee will expect that issues such as housing, education of children, and recreation will be taken care of. So, all these things must be addressed in the policy.

Key Components of an International Compensation Program

The key components of an international compensation program are as follows:

- i) Base Salary,
 - ii) Foreign Services Inducement/Hardship premium,
 - iii) Allowances, and
 - iv) Benefits.
- i) **Base Salary:** The term base salary acquires a somewhat different meaning when employees go abroad. In a domestic context, base salary denotes the amount of cash compensation that serves as a benchmark for other compensation elements (e.g., bonuses and benefits). For expatriates, it is the primary component of a package of allowances, many of which are directly related to base salary (e.g., Foreign Service premium, cost-of-living allowance, and housing allowance) as well as the basis for in-service benefits and pension contributions. It may be paid in home or local-country currency. The base salary is the foundation block for international compensation whether the employee is a PCN or TCN. Major differences can occur in the employee's package depending on whether the base salary is linked to the home country of the PCN or TCN or whether an international rate is paid.
 - ii) **Foreign Service Inducement/ Hardship Premium:** Parent-country nationals often receive a salary premium as an inducement to accept a foreign assignment or as compensation for any hardship caused by the transfer. Under such circumstances, the definition of hardship, eligibility for the premium, and amount and timing of payment must be addressed. Foreign Service inducements, if used, are usually made in the form of a percentage of salary, usually 5 to 40 percent of base salary. Such payments vary

depending upon the assignment, actual hardship, tax consequences, and length of assignment.

- iii) Allowances:** Issues concerning allowances can be very challenging to a firm establishing an overall compensation policy, partly because of the various forms of allowances that exist, such as follows:
- a) The cost-of-living allowance (COLA), which typically receives the most attention, involves a payment to compensate for differences in expenditures between the home country and the foreign country (e.g., to account for inflation differentials). Often this allowance is difficult to determine, so companies may use the services of organizations such as Organization Resource Counselors, Inc., (a U.S. –based firm) or Employment Conditions Abroad (based in Britain) who specialize in providing regularly updated COLA information on a global basis to their clients; the COLA may also include payments for housing and utilities, personal income tax, or discretionary items.
 - b) The provision of a housing allowance implies that employees should be entitled to maintain their home-country living standards (or, in some cases, receive accommodations that are equivalent to that provided for similar foreign employees and peers). Such allowances are often paid on either an assessed or an actual basis.
 - c) There is also a provision for home leave allowances. Many employers cover the expense of one or more trips back to the home country each year. The purpose of paying for such trips is to give expatriates the opportunity to renew family and business ties, thereby helping them to avoid adjustment problems when they are repatriated.
 - d) Education allowances for expatriates' children are also an integral part of any international compensation policy. Allowances for education can cover items such as tuition, language class tuition, enrollment fees, books and supplies, transportation, room and board and uniforms.
 - e) Relocation allowances usually cover moving, shipping, and storage charges, temporary living expenses, subsidies regarding appliance or car purchases (or sales) and down payments or lease-related charges.
 - f) Many multinational firms are also offering spouse assistance to help guard against or offset income lost by an expatriate's spouse as a result of relocating abroad.

Multinationals generally pay allowances in order to encourage employees to take international assignments and to keep employees "whole" relative to home standards. In terms of housing, companies usually pay a tax-equalized housing allowance in order to discourage the purchase of housing and / to compensate for higher housing costs; this allowance is adjusted periodically, based on estimates of both local and foreign housing costs.

- iv) **Benefits:** The complexity inherent in international benefits often brings more difficulties than when dealing with compensation. Pension plans are very difficult to deal with country to country because national practices vary considerably. Transportability of pension plans, medical coverage, and social security benefits are very difficult to normalize. Therefore, firms need to address many issues when considering benefits including:
- Whether to maintain expatriates in home-country programs, particularly if the firm does not receive a tax deduction for it.
 - Whether firms have the option of enrolling expatriates in host –country benefit programs and/or making up any difference in coverage.
 - Whether expatriates should receive home-country or host-country social security benefits.

Approaches of International Compensation

There are two main approaches of international compensation, such as follows:

- i) The Going Rate Approach, and
- ii) The Balance-Sheet Approach

i) The Going Rate Approach

The key characteristics of this approach are summarized in the following table-1.

Table 1: Characteristics of Going Rate approach

<ul style="list-style-type: none"> ◆ Based on local market rates ◆ Relies on survey comparisons <ul style="list-style-type: none"> - Local nationals (HCNs) - Expatriates of same nationality - Expatriates of all nationalities ◆ Compensation based on the selected survey compensation ◆ Base pay and benefits may be supplemented by additional payments for low-pay countries

In this approach, the base salary for international transfer is linked to the salary structure in the host country. The multinational usually obtains information from local compensation surveys and must decide whether local nationals (HCNs), expatriates of the same nationality, or expatriates of all nationalities will be reference point in terms of benchmarking. For example, a Japanese bank operating in New York would need to decide whether its reference point would be local U.S. salaries, other Japanese competitors in New York, or all foreign banks operating in New York. With the Going Rate Approach, if the location is in a low-pay country, the multinational usually supplements base pay with additional benefits and payments. There are advantages and disadvantages of the going Rate Approach that are summarized in the Table-2.

Table 2: Advantages and Disadvantages of the Going Rate Approach

Advantages	Disadvantages
<ul style="list-style-type: none"> ▪ Equity with local nationals ▪ Simplicity ▪ Identification with host country ▪ Equity amongst different nationalities 	<ul style="list-style-type: none"> ▪ Variation between assignments for same employee ▪ Variation between expatriates of same nationality in different countries ▪ Potential re-entry problems

ii) The Balance-Sheet Approach

Many multinational companies commonly apply the balance-sheet method for determining expatriate compensation. The balance-sheet method provides a compensation package that attempts to equate or balance an expatriate’s purchasing power in his or her home country. To balance the compensation received for the international assignment with compensation received in the home country, multinational companies usually provide additional salary. This increased salary includes adjustments for differences in taxes, housing cost, and the cost of basic goods and services. Goods and services include items such as food, recreation, personal care, clothing, education, home furnishing, transportation, and Medicare (Dowling and Schuler, 1990). Figure-2 indicates a simple view of how the balance-sheet approach works.

Figure 2: A Balance-Sheet Approach to Expatriate Compensation

Domestic Assignment: Expenses and Spend able Income:		Expatriate Assignment: Expenses and balanced Spend a Income + Allowances:	
Base Salary	+	Base Salary	
	=		
Taxes	=	Taxes	
	+		
Goods and Services	=	Goods and Services	
	+		
Housing	=	Housing	
	+		
Spend able Income	=	Spend able Income	

<input checked="" type="checkbox"/>	Allowances as an incentive to take position, foreign service premium hardship pay. R&R
<input checked="" type="checkbox"/>	
<input checked="" type="checkbox"/>	Allowances to balance extra tax payments.
<input type="checkbox"/>	Allowances to cover cost of living differences housing, children's education, medical costs, automobile, recreation, home leave travel

Besides matching the expatriate's purchasing power, companies often provide other allowances and perquisites to the expatriate manager. These cover the initial logistics of the international move (such as hotel costs while settling in), provide compensation for life style differences between the home and host country, and provide incentives to take the assignment. Some of these additional allowances and perquisites include the following (Black, Gregerseen and Mendenhall, 1992):

- i) **Foreign Service Premiums:** Multinational compensations often provide 10 percent to 20 percent of base pay for accepting the individual and family difficulties associated with an overseas assignment.
- ii) **Hardship Allowance:** This is extra money paid for particularly difficult posting due to issues such as high risk or poor living conditions.
- iii) **Relocation allowance:** Along with the basic costs of moving a family to an international assignment, many companies pay a flat sum equal to one month's salary at the beginning and end of the assignment to cover miscellaneous costs of relocating.
- iv) **Home-Leave Allowances:** These provide transportation costs for expatriates and their families to return to their parent country once or twice a year.

There are some advantages and disadvantages of the balance-sheet approach, which are summarized in the following table.

Table 3: Advantages and Disadvantages of the Balance-Sheet approach

Advantages	Disadvantages
<ul style="list-style-type: none"> ▫ Equity <ul style="list-style-type: none"> - between assignments - between expatriates of the same nationality ▫ Facilitates expatriates re-entry ▫ Easy to communicate to employees 	<ul style="list-style-type: none"> ▫ Can result in great disparities <ul style="list-style-type: none"> - between expatriates of different nationalities - between expatriates and local nationals ▫ Can be quite complex to administer

Findings of the Study

On the basis of the objectives of the paper, the findings of the study are as follows:

1. The policy of parent country and the policy of host country are not same as well as the working environments, nature of the tasks and so on are also different between parent country and host country. That is why the multinational companies are frequently facing difficult problems to prepare the appropriate compensation package for expatriate managers.
2. Now, those multinational companies operating business throughout the world (Nestle, Thomson, Unilever, Philips, Roche, Solvay, Seagram, Electrolux, Holderbank Finaciere and so on-UNCTAD, 1995) are using two basic approaches to prepare their expatriate compensation such as the Going Rate Approach, and Balance-Sheet approach. But both approaches have some disadvantages. As a result, it is quite impossible for multinational companies to prepare standard compensation package for their expatriate managers with the help of these approaches.
3. Most of the managers working in the Head Quarters of multinational companies throughout the world are lagging behind in knowledge about the ends and outs of expatriate compensation. Because of these reasons, they are largely depending on the experts, consultants or consulting firms.

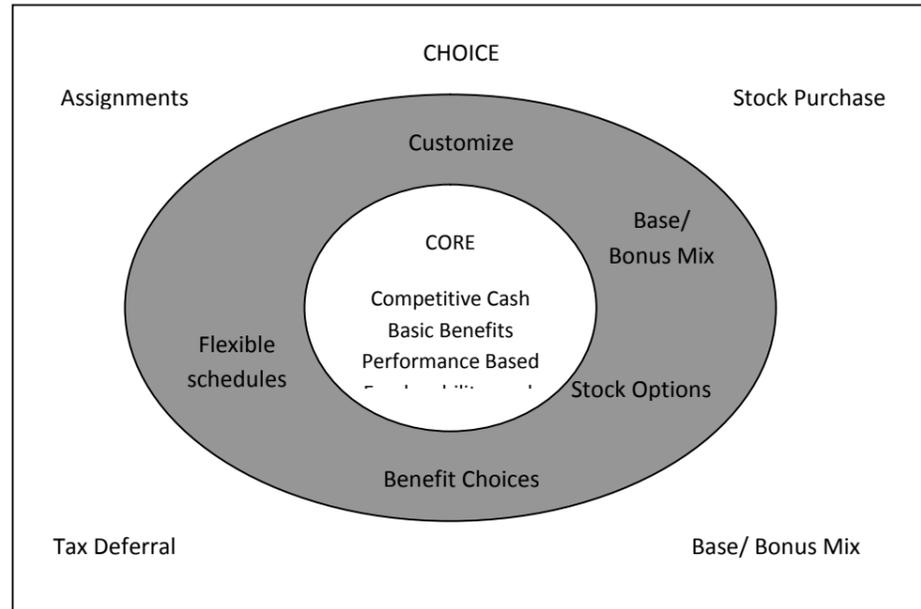
Policy Recommendations

The following recommendations will help the multinationals authority to prepare the standard compensation packages for the expatriate managers:

1. The managers of multinational companies should formulate the standard pay policies which will help them to prepare the attractive compensation packages for expatriate managers. In this regard, the manger should consider the working environment, nature of the task, and so on are both the parent and host country while preparing the international compensation policy.

2. Because of the disadvantages of Going rate and Balance Sheet Approach of international compensation, the managers of the multinational companies may use the strategic flexibility model to prepare the compensation package for the expatriate managers. The strategic flexibility model has been shown in the following figure:

Figure 3: Strategic Flexibility Model of International Compensation



Source: G.T. Milkovich, and M. Bloom, 1998. *Rethinking international compensation*, *Compensation and Benefits Review*, vol.30, no.1, p.22.

This model groups forms of total compensation into three sets: core, crafted, and choice. Specific practices in the core section may vary according to market and local conditions but must be consistent with core policies. The crafted set of compensation elements assumes that regional managers have discretion to choose from a menu of compensation forms, while alternatives in the choice set offer flexibility for employees to select among various forms of compensation. So, I can say that this model will help the managers of multinational companies to prepare the attractive and competitive compensation package for the expatriate managers.

3. The higher authority of multinational companies should give the development (skills, knowledge, abilities, competencies and experiences) through conferences, open discussions, summits, round-table discussions, foreign assignments, case studies and so on to their managers so that the managers can develop themselves and they can play

necessary role with the experts, consultants or consulting firms while preparing compensation packages for the expatriate managers.

Concluding Remarks

There is no doubt that compensation is very much important for the employees and the multinational companies. It is important for the employees because employees are selling their time, life, labor, skill, knowledge, and expertise to the organization to earn money in order to maintain their standard of living. Side-by-side it is also important for the companies because compensation is directly related with the cost and profit of the companies. So, the managers of multinational companies should prepare the compensation policy in such a way that will serve the interest of employees and multinational companies.

Future Research Direction

Future research could test the extent to which the strategic flexibility model describes how multinational companies are reacting to the complexities they face in dealing with international compensation.

Bibliography

- Bouache, J., and Fernandez, 1997. Expatriate Compensation and its link to the Subsidiary Strategic Role: A Theoretical Analysis, *International Journal of Human Resource Management*, Vol. 8, No.4, pp. 457-475.
- The Conference Board, 1996. *Managing Expatriates' Return: A Research Report*, Report # 1148-96-RR, New York.
- Tomlinson, Richard, 2008. You get what you pay for, corporate recruits in China Find Fortune, April 28, pp. 218-219.
- Lublin, M. and Smith, J., 2007. Expatriate Compensation Decision Making, *International Journal of Business*, Vol. 9, No. 3, pp. 251-280.
- Tung, R.L., 1988. Career Issues in International Assignments, *Academy of Management Executive*, Vol. 2, No. 3, pp. 241-244.
- Harvey, M., 1993. Empirical Evidence of Recurring International Compensation Problems, *Journal of International Business Studies*, Vol. 24, No. 4, pp. 163-178.
- Harzing, M., 1998. The International Mobility of Expatriate Managers, *European Management Journal*, Vol. 15, No. 5, pp. 584-590.
- Schuler, R.S., and Rogovsky, N., 1998. Understanding Compensation Practice Variations Across Firms: The Impact of National Culture, *Journal of International Business Studies*, Vol. 29, No. 1, pp. 159-177.
- Dowling, Peter, J., and Schuler, R.S., 1990. Expatriate Compensation and Benefit: An Exploratory Study, *Journal of International Business Studies*, Vol. 20, No. 3, pp. 225-302.
- Black, J.S., Gregersen, H.B., and Mendenhall, M.E., 1992. Problems involved with the International Comparisons of the Cost of Living, *Journal of International Business Studies*, Vol. 23, No. 4, pp. 184-194.