Chapter 5
International Compensation Management

IHRM

Welingkar Hybrid Program

Chapter Objectives

By the end of this chapter, you will understand:

- How to manage international compensation
- What are the challenges in international compensation

Chapter Structure

1. Managing international compensation
2. Challenges in international compensation
3. Conclusion: Is it just about the money?
4. Summary

1. Managing International Compensation

- Managing compensation internationally is a tricky area.
- International HR managers have to think beyond the set theories and be highly aware of the trends and conditions all over the world.
- For Example: Japanese electronics giant Panasonic has announced plans to pay expat workers in China a wage premium to compensate for dangerous air pollution.
- The employer is thinking beyond the traditional expat package and giving an allowance that shows a high amount of care and the employee is bound to feel valued.
- The objective of managing compensation is to ensure that an organization has an edge in terms of having the right talent at the right place and the right time.
- If compensation is not managed proactively, managing expatriates can prove to be a big challenge.

- The economic trends in the world keep swinging between ‘economic prosperity’ and ‘cost cutting’.

- In such an environment, many corporate react with sudden withdrawal of benefits without considering what impact it may have on employees.

- Compensation is a tool used by management for a variety of purposes to further the existence of the company.

- Compensation may be adjusted according to the business needs, goals, and available resources.

- Compensation may be used to:
  - Recruit and retain qualified employees.
  - Increase or maintain morale/satisfaction.
  - Reward and encourage peak performance.
  - Achieve internal and external equity.
  - Reduce turnover and encourage company loyalty

- Compensation is based on:
  - Market research about the worth of similar jobs in the marketplace,
  - Employee contributions and accomplishments,
  - The availability of employees with like skills in the marketplace,
  - The desire of the employer to attract and retain a particular employee for the value they are perceived to add to the employment relationship, and
  - The profitability of the company or the funds available in a non-profit or public sector setting, and thus, the ability of an employer to pay market-rate compensation.

- Compensation responsibilities of any HRM manager
  - International Compensation System is understood as provision of monetary and nonmonetary rewards including Base Salary, Benefits, Perquisites, long and short term incentives in accordance with their relative contribution to performance.
  - Attract Individuals who are competent and interested in foreign assignments.
  - Facilitate movements of Expatriates from one subsidiary to another, from one home country to subsidiaries, from subsidiaries back to home country
  - Consistent pay levels at Headquarters, Domestic affiliates, and foreign subsidiaries.
  - Be Cost effective by minimizing unnecessary expenses.
  - Be consistent with the overall strategy, structure and business needs.

Components of an International Compensation package

Base Salary

- Expatriate salaries typically are set according to the base pay of the home countries.

- Therefore, a German Manager working for a US MNC and assigned to Spain would have a base salary that reflects the salary structure in Germany.

- The salaries usually are paid in Home currency, local currency, or a combination of the two.

- The base pay also serves as the benchmarks against which bonuses and benefits are calculated.

Components of an International Compensation package

Benefits

- Alternatively known as indirect compensation,
- Benefits constitute a substantial portion of international compensation (approx. one third of compensation for regular employees is benefits).
- Benefits include a suit of programmes such as: – Entertainment, Festival celebrations, Gifts, Use of club facilities, provision of hospitality including food and beverage, employee welfare, use of health club, Conveyance tour and travel, Hotel Board and Lodging, vehicles, telephone and other telecommunication facilities, Sponsorship of children.
- Basically an employee tends to join and stay with an organization which guarantees an attractive benefits programme.
- Vacation along with holidays and rest breaks help employees mitigate fatigue and enhance productivity during the hours employees actually work.

S.P MANDALI'S weschool Welingkar Education

Components of an International Compensation package

Allowance

- It is an inevitable feature of International compensation. The most common allowance relates to the cost of living – an adjustment for different in the cost of living between the home country and foreign country assignment. This allowance is designed to provide the expatriate with the same standard of living that he or she enjoyed in the home country.

- **Spouse assistance, housing allowance, home leave allowance, relocation allowance and educational allowance are the popular in expats compensation.**

- These allowances are often contingent upon tax – equalization policies and practices in both the home and the host countries.

Components of an International Compensation package

Incentives

- An additional payment (or other remuneration) to employees as a means of increasing output. Increasingly, MNCs these days are designing special incentive programmes for keeping expatriates motivated. In the process, a growing number of firms have dropped the ongoing premium for overseas assignments and replaced it with a one – time, lump-sum premium.

- The lump – sum payment has at least three advantages:
  - First, expatriates realizes that they are paid this only once and that too when they accept an overseas assignment. So the payment tends to retain its motivational value.
  - Second: costs to the company are less because there is only one payment and no future financial commitment. This is so because incentive is a separate payment, distinguishable from a regular pay, and it is more rapidly for saving or spending.
  - Third, less chances for pre mature repatriation.

Components of an International Compensation package

Foreign Service/Hardship Premium

- This is often perceived as an inducement in the form of a salary premium to accept an overseas assignment.

- Generally, salary premiums vary from 5—40% of the base salary. Actual salaries depend upon the assignment, actual hardship, tax consequences and length of assignment.

- In addition, if the work – week in the host country is longer than in the home country , the assignee will be paid for the extra hours worked.

- Certain countries are highly hostile to foreigners staying and working. Expatriates in such environments are paid 2-3 times more than their domestic salaries.

- Indians engaged in road construction work in Afghanistan, for example, face constant threat to their lives.

Components of an International Compensation package

Long Term Benefits

- The most common long term benefits offered to employees of MNCs are **Employee Stock Option Schemes (ESOS)**. Traditionally E-SOS were used as means to reward top management or key people of the MNCs. Some of the commonly used stock option schemes are:

  - Employee Stock Option Plan (ESOP) - a certain nos. of shares are reserved for purchase and issuance to key employees. Such shares serve as incentive for employees to build long term value for the company.

  - Restricted Stock Unit (RSU) – This is a plan established by a company, wherein units of stocks are provided with restrictions on when they can be exercised. It is usually issued as partial compensation for employees. The restrictions generally lifts in 3-5 years when the stock vests

  - Employee Stock Purchase Plan (ESPP) – This is a plan wherein the company sells shares to its employees usually, at a discount. Importantly, the company deducts the purchase price of these shares every month from the employee's salary

S.P MANDALI'S weschool Welingkar Education

Components of an International Compensation package

Taxes

- The final component of the expatriate's remuneration relates to taxes. MNCs generally select one of the following approaches to handle international taxes:
  - Tax equalization: Firms withhold an amount equal to the home country tax obligation of the expatriate, and pay all taxes in the host country.
  - Tax protection: The employee pays up to the amount of taxes he or she would pay on remuneration in the home country. In such a situation, the employee is entitled to any windfall received if total taxes are less in the foreign country than in the home country.

Compensation Philosophy

- The basis of deciding compensation for any expatriate is the Compensation Philosophy of the organization.
- Compensation philosophy is the set of values and beliefs an organization has with regard to monetary and non-monetary rewards payable to the employees.
- Differences in compensation philosophies are wide spread.
- Some MNCs, in order to attract the best talent, seek to pay at the top of the market. Some other MNCs are more generous to certain levels of super performers while others work to retain equity across all levels and employees.
- Therefore, the compensation philosophy of an organization plays a big role in the sort of remuneration an employee draws from there.

Theories of Compensation

Contingency Theory

- Contingency theory is most popularly followed in international compensation.
- According to this theory, expatriate compensation should be based on particular contingencies or situations prevailing in the host country.
- Typically, therefore, these organizations believe that the same compensation rule cannot apply to expatriates across the globe.
- The compensation philosophy in such organizations is normally de-centralized and allows units to localize the compensation structure.

Theories of Compensation

Resource Based Theory

- This theory suggests that an MNC should pay well to attract and train competent people who contribute to its competitive advantage.

- Human resource consists as the greatest asset of MNC and the firm should do anything to acquire, retain and use it for organizational effectiveness. It is a challenge in such organizations to ensure a fixed structure and stay 0within clearly defined salary bands.

- Such organizations remain market sensitive and are constantly reviewing compensation to retain their position in hiring and retaining of talent.

Theories of Compensation

The Agency Theory

- This theory focuses on the divergent interests and goals of an organization's stakeholders and the way that employee compensation can be used to align these interests and goals.

- According to this theory, there exists a principal – agency relationship between MNC's headquarters and subsidiaries, the former being the principal and the latter acting as agents.

- Given that the headquarters do not have the unique knowledge of the subsidiaries, not all decisions in the MNC can be made by the headquarters.

- It must depend on the subsidiaries and their goals must be mutually aligned.

Theories of Compensation

Equity Theory

- Equity theory believes that there should be an equal balance between what the expatriate contributes and what he receives as compensation. Inequity between the two will result in low performance.
- Establishing the equity principle in a domestic business may be relatively easy but in international compensation, this is a daunting task.
- Relativities are much more difficult to establish in an MNC due to its geographic and cultural spread and its workforce mix of home, host and third country nationals.

Compensation Strategy

Nation and Region Based

- There is considerable difference in compensation and rewards not only across nations but also within nations.

- Recent studies done in China, for example, show that pay packages provided in state owned enterprises emphasize benefits like housing, food, healthcare, childcare, etc and relatively lower cash.

- Joint ventures and wholly foreign owned subsidiaries use widely divergent approaches, some emphasizing highly risky variable pay while others emphasizing training, career development and moderate cash.

Compensation Strategy

National Culture Based

- Sociologists proposed that each nation has a culture – for example Geert Hofstede (Power Distance, Individualism-Collectivism, Uncertainty Avoidance, and Masculinity-Femininity) and some others as well.

- Following this view, some argue that compensation strategies differ with the national cultures - compensation systems in countries where the culture emphasizes respect for status and hierarchy and thus produces higher power distance scores (Malaysia and Mexico) should exhibit more hierarchical pay structures, while those manifesting low power distance (Australia and the Netherlands) would choose more egalitarian systems.

- In nations identified as individualistic (U.S., U.K., Canada), compensation and rewards would support employability and individual and performance-based pay.

Compensation Strategy

National Culture Based

- This national culture approach prescribes that compensation and reward policies must be aligned with and reinforce attributes of national culture.

- It has long been recognized that compensation and reward systems, because of their social as well as economic significance, exemplify and reinforce cultural norms.

- Closer analysis reveals that political, economic, institutional, and other forces (rather than national culture) explain a significant amount of variation in the expressed desires of employees from different countries.

Compensation Strategy

Organization Culture Based

- Compensation and reward systems can become an important signal of an organization' culture and values.

- As such, the systems help create cultures or mind-sets that are different and distinct from the cultures and values of competing firms.

- Hewlett-Packard and Microsoft both compete vigorously for software engineers, yet each company exhibits a different corporate culture, signaled by and reinforced in their respective compensation systems.

- Given sufficient variation in values among the people in the labor pools of a nation, firms can structure compensation policies that are consistent with the firm's culture and simultaneously attract individuals from the applicant pool who have similar values.

Compensation Strategy

Strategic Flexibility

- Strategic flexibility in global compensation and reward systems starts with understanding how the company plans to win.

Traditional to Strategic Flexibility

TRADITIONAL		STRATEGIC FLEXIBILITY
Insures Expatriates' Balance Sheet	→	Create Global Mindset; Achieve Strategic Priorities
Focus on Differences Among Nations	→	Leverages Differences Within Nations
Act Like National Culture	→	Grow Corporate Culture
Focus Total Compensation Package	→	Manage Total Value of Employment; Financial and Relational Forms
Manage Multiple Compensation Systems	→	Manage Multiple Deals

Compensation Strategy

Strategic Flexibility

- Flexibility is based on the premise that understanding and managing total compensation in a global business shifts thinking away from using a balance sheet to keep expatriates economically whole or relying on stereotypical notions of differences among nations.

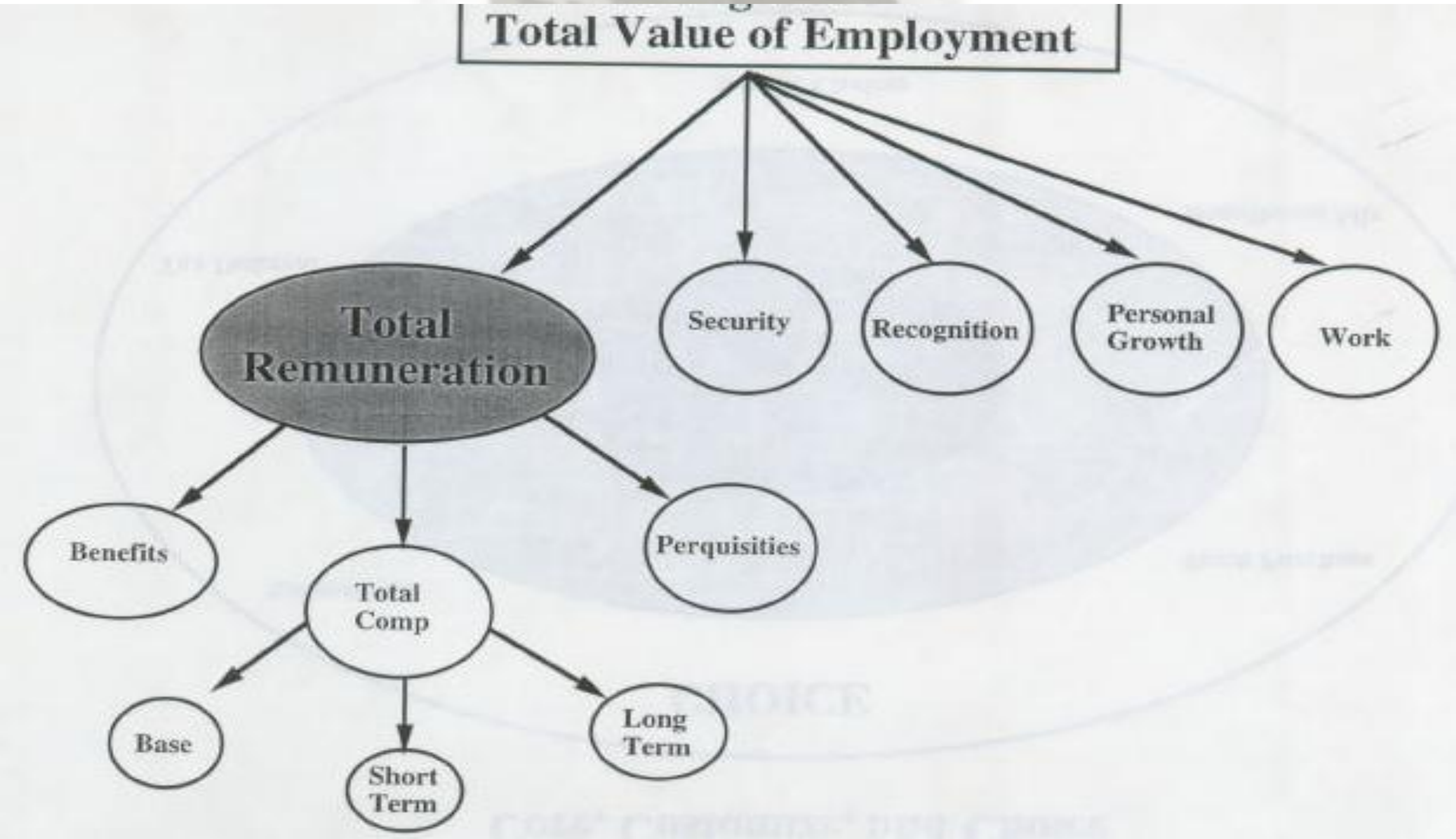
- The focus, rather, is on understanding and leveraging differences within and between nations.

- Strategic flexibility means that companies achieve advantage by customizing multiple compensation and reward systems.

- Creating and managing multiple deals to support a global business is consistent with the current practice of broadening the definition of total compensation to include the total value of employment.

Compensation Strategy
Strategic Flexibility

- Total compensation includes cash, benefits, and long term incentives as well as employment security conditions, flexible work schedules, learning opportunities, and so on.



Compensation Strategy
Strategic Flexibility

- There is a growing realization that focusing only on the financial forms of total compensation creates transactional relationships that can be easily copied or purchased by competitors.

- Financial returns alone cannot extract the unique, value-adding ideas and behaviours possessed by employees.

- Strategic flexibility also includes a broader thinking that includes both financial and ***Relational returns***.

- Relational returns may bind individuals more strongly to the organization because they can answer those special individual needs that cannot be met as effectively with economic returns

- For example : providing for childcare via the noneconomic return of flexible work schedules, versus the financial return of salary to pay for childcare. The flexible schedule puts a parent, not a caregiver, at home.

Compensation Strategy

Strategic Flexibility

- Flexibility, choice, and managing risk form the essence of this thinking. It begins by viewing the employment relationship as an exchange.

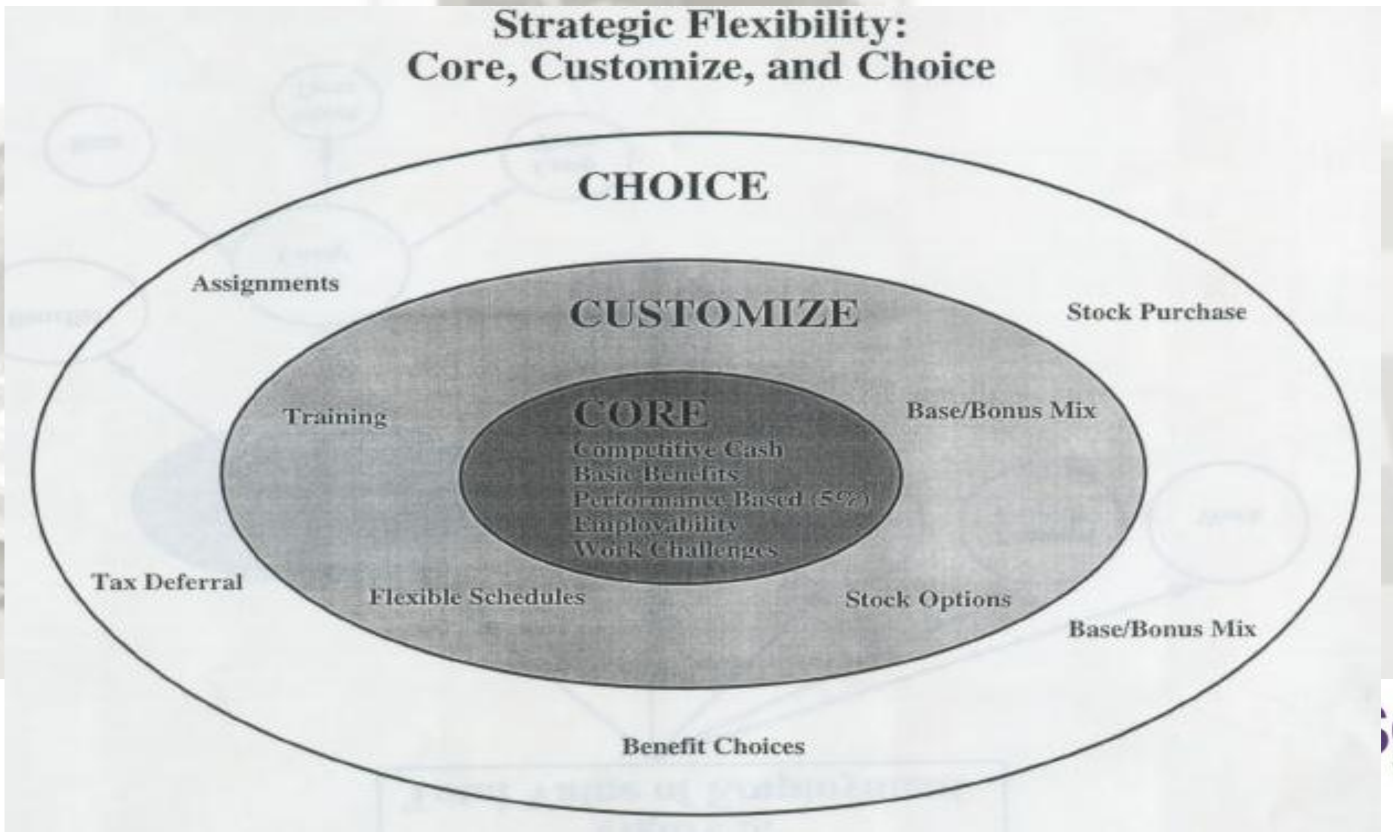
- Under this view, both the employer and employee make contributions and extract returns from the relationship.

- A critical principle is that the returns offered by the employer are the primary determinants of the contributions provided by employees.

Compensation Strategy

Strategic Flexibility

- The model below groups different forms of total compensation into three sets: core, crafted, and choice. It includes any return an organization can offer that employees see as a reward or a return for the contributions they make on the organization's behalf.



Compensation Strategy

Strategic Flexibility

- The ***core*** section of the model includes compensation and reward forms that signal the corporate global mind-set (example: creating a customer service culture).

- The ***crafted*** set of compensation elements in the figure assumes that business unit or regional leaders have discretion to choose among a menu of total compensation forms that may be important to gain and sustain advantage in the markets in which they operate. For example, some form of housing assistance may make sense in Shanghai, whereas in London or Tokyo, transportation assistance may make more sense.

- The alternatives in the ***choice*** set offer flexibility for employees to select among various forms of total compensation. Example here might include opportunities to take educational leaves to become eligible for regional or global assignments.

Compensation Strategy

Strategic Flexibility

- The strategic flexibility model offers managers the opportunity to tailor the total compensation system to fit the context in which they compete within a framework of corporate principles.
- For some companies, the strategic flexibility model simply draws existing practices under one umbrella. For example, it treats expatriates as simply another group, much like sales disciplines.
- Other companies operate with their international compensation and reward systems pointed in many different directions.

Compensation Approaches

Balance Sheet Approach

- This approach integrates the base salary for PCNs and TCNs to the salary structure of the home country. There are three main advantages of this approach.
  - Provides equity between assignments and between expatriates of the same nationality.
  - Ease of Communication.
  - Due to the consistency between the compensation system and the compensation system in the parent country, the repatriation process for expatriates is facilitated.

Compensation Approaches

Balance Sheet Approach

- The primary disadvantage of this approach is that:
  - it can result in significant disparities between expatriates from different nationalities and between expatriates and locals doing the same work.
  - It is also complex to administer.

Compensation Approaches

Going Rate Approach

- This approach is primarily based on the local market rates.
- It relies heavily on survey comparisons among local nationals, expatriates of the same nationality and expatriates of all nationalities.
- The main advantage of this approach is that
  - pay equality with local nationals is facilitated
  - It also promotes equity amongst different nationalities doing the same work.
  - The approach is simple and easy for expatriates to understand
  - It provides greater identification with the host nation

Compensation Approaches

Going Rate Approach

- The main disadvantage of this approach is that
  - Variations in pay between assignments for the same expatriate and pay discrepancies between expatriates from the same nationality doing similar work in different nations.
  - This approach also causes potential re-entry challenges, particularly when expatriates have been receiving significantly more pay while on assignment as compared to their home nation.

Quick Check

Choose the correct option:

1. Base Salary of an expat is:
   A. The amount of money that he normally receives in his home country
   B. The allowance relating to the cost of living
   C. The additional payment an expat receives as a means for increasing output

2. To manage international compensation, an HR manager has to:
   A. Travel internationally to scout for talent all over the world
   B. Work on attracting individuals who are competent and interested in foreign assignments
   C. Keep up to date with agents who are experts on global relocations

Answers:

1. A 2. B

Chapter Structure

1. Managing international compensation
2. Challenges in international compensation
3. Conclusion: Is it just about the money?
4. Summary

S.P MANDALI'S weschool Welingkar Education

2. Challenges in international compensation

- A constant challenge for companies operating internationally is the need to balance providing remuneration packages competitive enough to attract the right people to meet company objectives with keeping costs down, particularly in the current economic climate.

- Dynamic growth in regions such as Asia and South America continues to provide commercial opportunities for companies, generating an even greater international demand for skilled and talented staff.

- In recent years, we have increasingly seen countries in these regions also emerge as expatriating countries and in the future there will be more movement out of these developing regions into the developed world.

Local Pay Issue

- A consequence of fast economic growth and generally higher inflation in developing countries is that local salaries there are increasing more rapidly than expatriate salaries.

- This is particularly evident in South America and in many developing Asian economies, such as China.

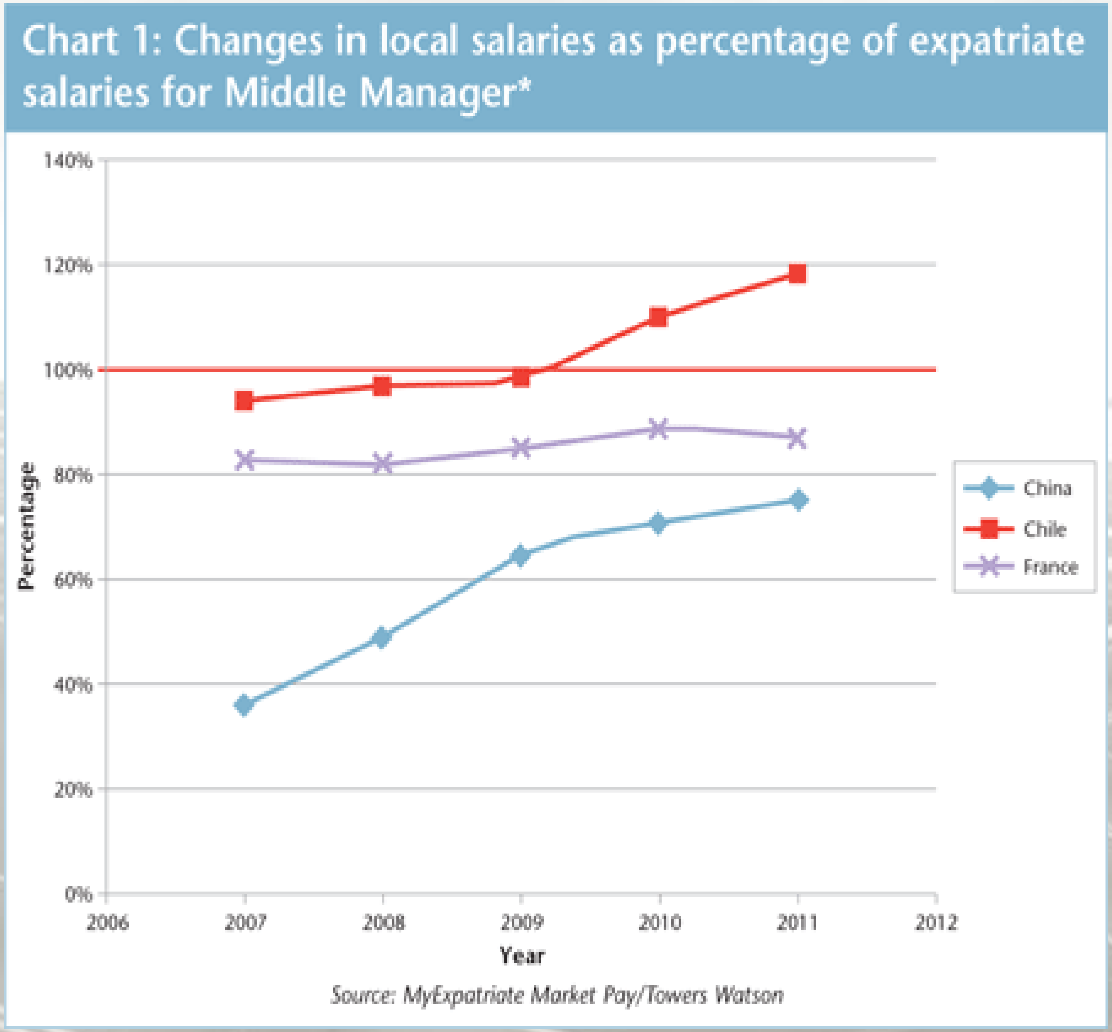
- However, in many developed countries, particularly those in the Eurozone, local salaries have risen only moderately due to low inflation and restricted GDP growth, and the same is also true of expatriate salaries there.

- A 'one size fits all' approach is unlikely to help the company succeed in attracting talent comprehensively.

Local Pay Issue

The chart shows changes in local Middle Manager salaries as a percentage of expatriate salaries at the same level over the last five years for China, Chile and France.

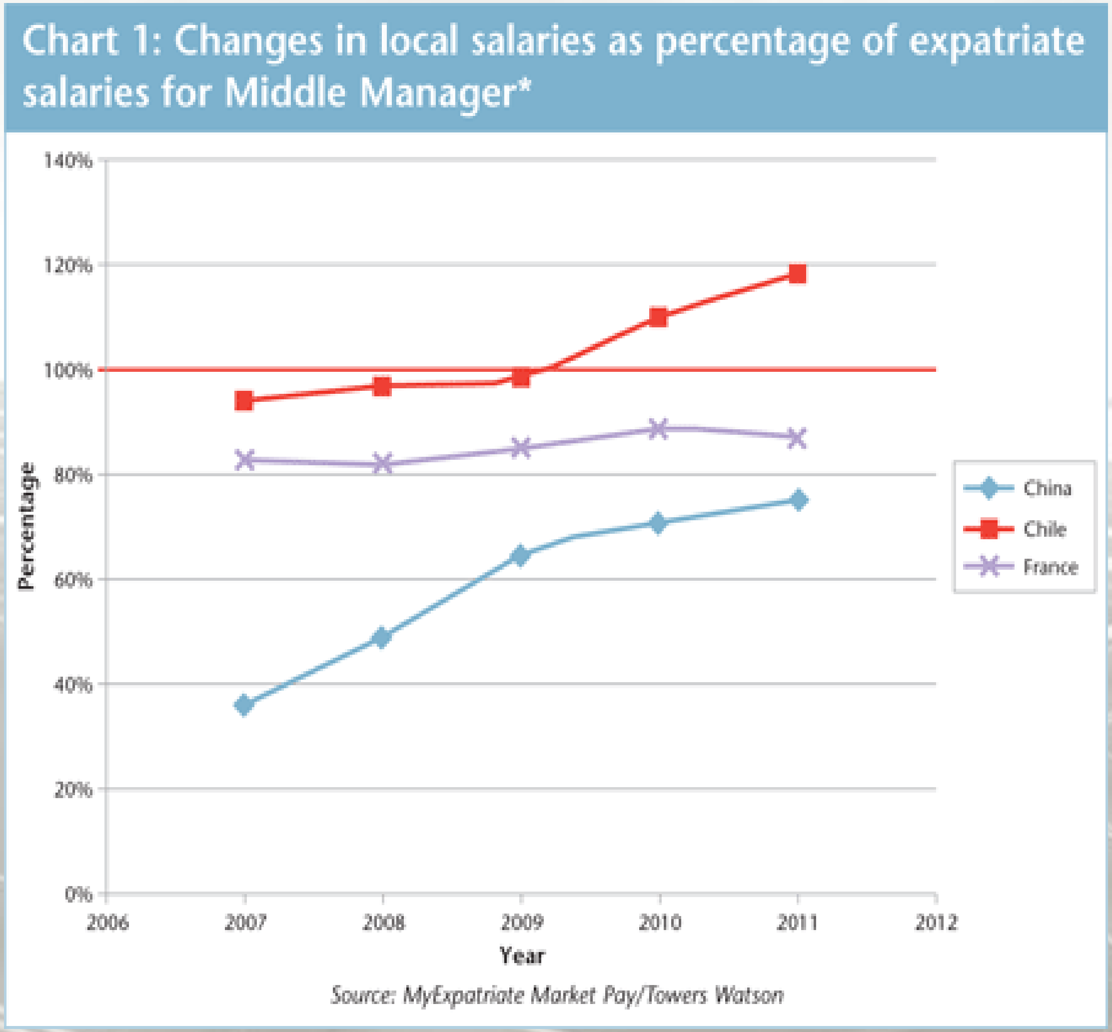
The steep rises in Chinese local salaries mean they are now fast approaching expatriate levels making a host-based salary system a more viable approach for companies with assignees there.



Local Pay Issue

In Chile, as in some other South American countries, local salaries have recently overtaken those of expatriates.

In France, on the other hand, both local and expatriate salaries remain fairly stable as is typical of many developed countries.



Local Pay Issue

- No matter which salary system is currently used for calculating an expatriate's salary it is important to keep track of local salaries.
- This enables a company to see how these fit relative to its assignees' pay and assess whether the current remuneration approach continues to meet and reinforce business objectives.
- While comparing local and expatriate salaries is not straightforward, it can certainly give an indication of whether a local salary system is an appropriate or cost-effective alternative to the home-based approach.
- When an expatriate employee sees their local counterpart’s salary is approximately 70% higher than their own, it is easy to understand how they could feel underpaid.
- Even though the expatriate may have extra benefits, such as accommodation, education allowances and more which might change the comparison – more on that later – the cash element is still important, even if it is only psychologically.

Expatriating from developing economies

- The large pay differences between seniority levels in the developing locations highlighted can also cause issues when expatriating out of them – a trend that is steadily increasing.

- For example, sending a junior manager on assignment from Brazil to Western Europe using a build-up approach may well result in an expatriate salary that is more or less in line with other expatriates and local pay levels and typical expatriate salaries.

- However, to use this approach for a senior employee will result in a huge cost to the company.

Expatriating from developing economies

- An employee from Brazil earning the average Brazilian executive salary on assignment in London on a typical build-up package could be earning around 75% more than the expatriate average in the UK at that seniority.

- The difficulty for the company in this case is that a senior Brazilian employee is unlikely to be willing to move to most of the traditionally high-salary, developed countries on a local package since they will lose the high buying power they are used to at home.

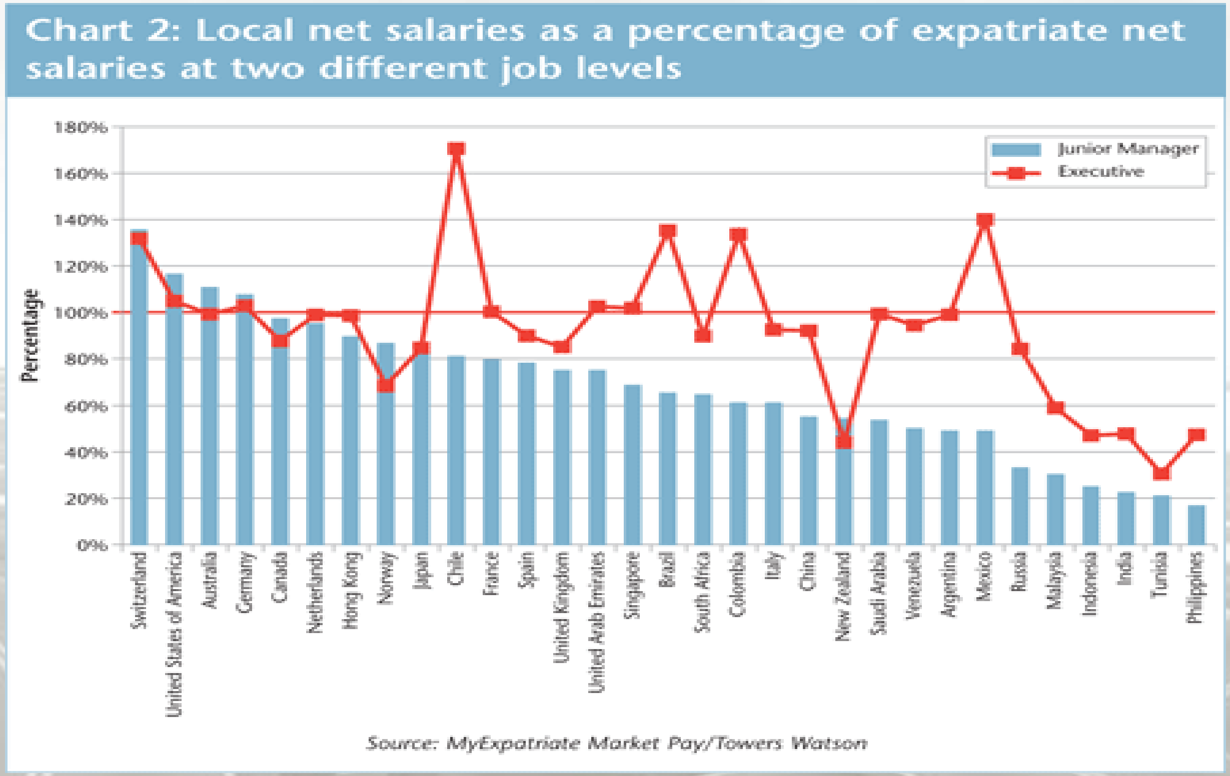
Global differences according to seniority

- The difference that may be seen between average net expatriate and local salaries can vary greatly according to seniority.
- Implementing consistent policies across all employees, no matter the seniority level or countries of origin and assignment, is likely to create problems.
- A flexible policy that can distinguish between the nationalities and seniority of the assignees is a more pragmatic solution and should be reinforced by managing expatriate expectations throughout the process.
- Another approach also worth considering is to look at sending employees on assignment earlier in their career when salaries are more likely to be similar.

Global differences according to seniority

Data shows that at junior managerial level, Switzerland has the highest local national net salaries relative to expatriate salaries, followed by the USA and Australia.

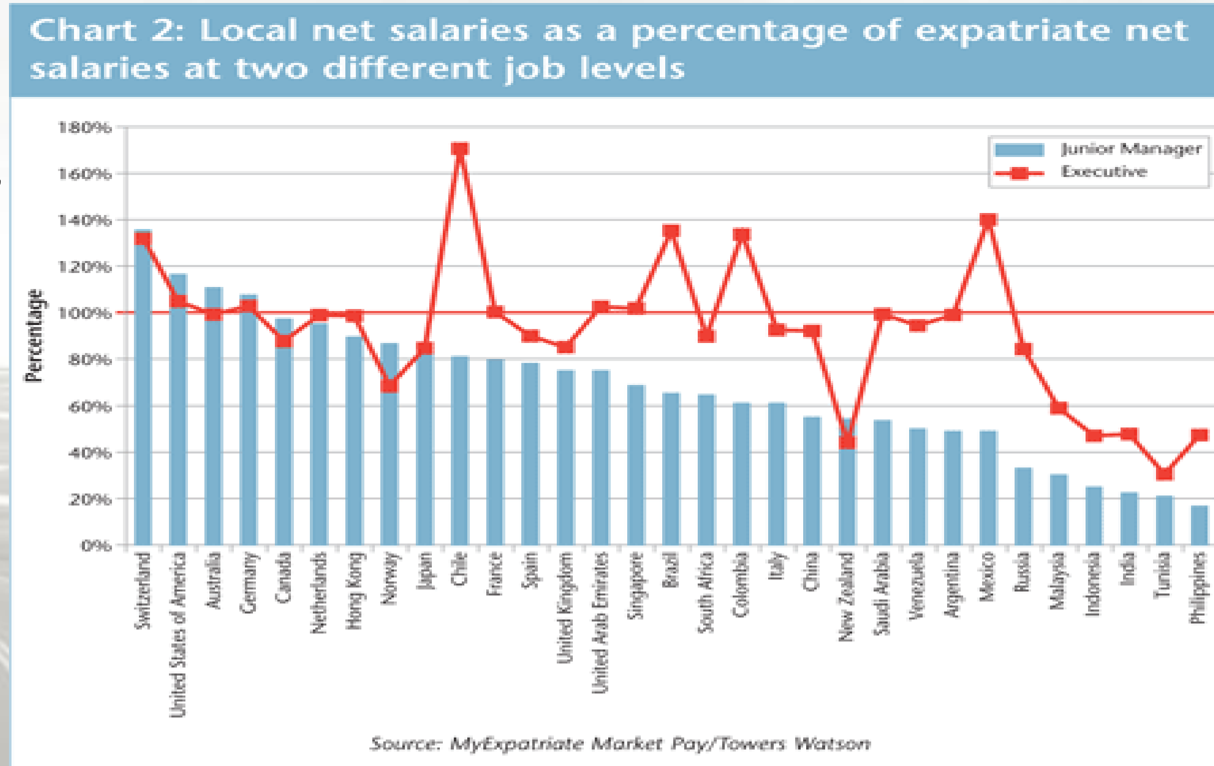
Several other western European countries, along with Canada and Hong Kong, are also at the top end of the scale.



Global differences according to seniority

South American economies of Chile, Brazil, Mexico and Colombia is where the highest local salaries relative to expatriate salaries are being witnessed.

Local salaries in these countries have been increasing steadily for several years.



Quick Check

Choose the correct option:

1. The Local Pay issue:
   A. Is the large pay difference due to seniority levels in expats
   B. Arises when an expatriate is moving from developing country to developed country
   C. Is the consequence of fast economic growth & inflation in developing countries

2. The issue expats face in moving from developing countries is that:
   A. They miss the local culture, people and food
   B. They feel lost in a developed country
   C. They lose the high buying power they are used to

Answers:

1. C 2. C

Chapter Structure

1. Managing international compensation

2. Challenges in international compensation

3. Conclusion: Is it just about the money?

4. Summary

3. Conclusion: Is it just about the money?

- Decades of research about expatriates has assumed that the fundamental driver for assignees to accept international assignments has been for financial gain.
- For many years this was indeed a major reason why expatriates agreed to go: few people are willing to uproot their lives, families, established networks and familiarity of home to simply “break even” in terms of home-country salary.
- The latest research shows, however, that the five top criteria for expatriates when making the decision to accept an international assignment go beyond only financial reasons.
- While base salary (71%) and a location bonus (to incentivize the move; 32%) are important, so too is accompanying partner support to assist in adjustment and the dual-career issue (finding employment; 60%), re-integration guarantees for an expatriate’s career (58%), and the quality of schooling for children (whether fully or partially funded by the company; 41%).

- We are witnessing a change in the drivers that motivate expatriates to go abroad, with corresponding changes in company's strategies to attract the right people into global employment and to keep them employed over the long term.

- For more and more expatriates, compensation, then, is a "means to an end" – it matters only to a point.

- A recent study found that financial gain becomes most important to expatriates only when a sudden change in remuneration causes them undue hardship or they are close to retirement.

- For some millennial expatriates as well as those climbing the ladder to middle management, it's often never about the money.

- Treating the assignees well, by communicating with them openly will foster harmonious and committed relationships through mutual respect and understanding for organizations.

Quick Check

Choose the correct option:

1. For expats, money as compensation is not everything. They also value :
   A. Promotions
   B. Relationships
   C. Children’s schooling

2. If financial ties bind an expat to an organization :
   A. He will never leave the organization
   B. The organization will benefit from him
   C. He can easily be hired by competition

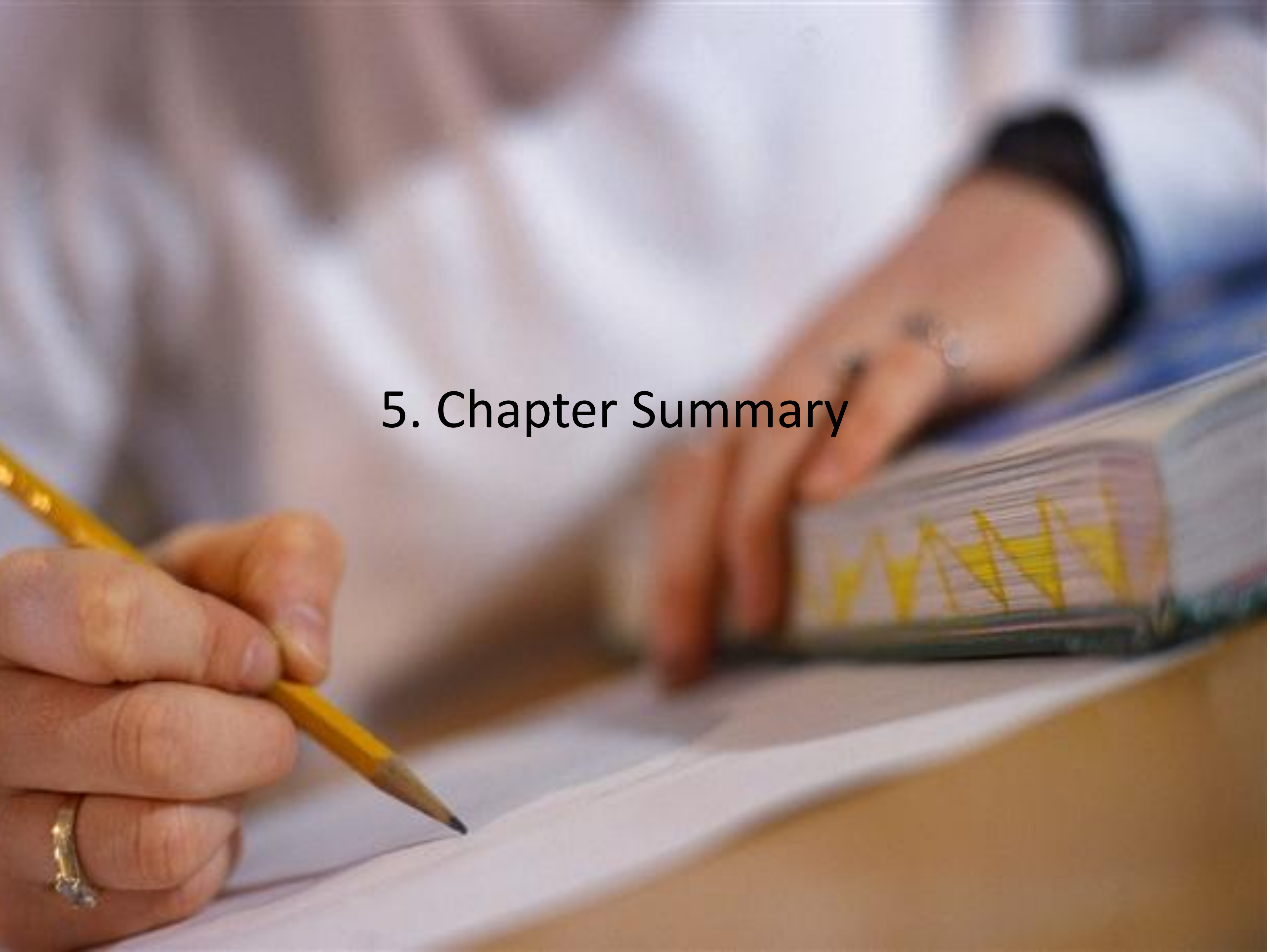
Answers:

1. C 2. C

Chapter Structure

1. Managing international compensation
2. Challenges in international compensation
3. Conclusion: Is it just about the money?
4. Summary

5. Chapter Summary



- Compensation is a tool used by management for a variety of purposes to further the existence of the company. Compensation may be adjusted according to the business needs, goals, and available resources.

- International HR is a challenging job for any Human Resource Manager and an important and complex part of this tough job is managing the compensation of employees who are part of these international employees.

- International Compensation System is understood as provision of monetary and nonmonetary rewards including Base Salary, Benefits, Perquisites, long and short term incentives in accordance with their relative contribution to performance.

- Components of international compensation comprises the base salary, incentives, benefits, allowances, foreign service inducement/ hardship premium, long term benefits and taxes etc.

- The basis of deciding compensation for any expatriate is the Compensation Philosophy of the organization. Compensation philosophy is the set of values and beliefs an organization has with regard to monetary and non-monetary rewards payable to the employees.

- There are four theories for international compensation – Contingency, Resource – based, Agency and Equity.

- Contingency theory is most popularly followed in international compensation. According to this theory, expatriate compensation should be based on particular contingencies or situations prevailing in the host country.

- Resource Based Theory states that an MNC should pay well to attract and train competent people who contribute to its competitive advantage.

- Agency Theory focuses on the divergent interests and goals of an organization's stakeholders and the way that employee compensation can be used to align these interests and goals.

- Equity theory believes that there should be an equal balance between what the expatriate contributes and what he receives as compensation.

- Organizations have varied strategies to manage international compensation. However, the strategy that currently works best is *Strategic Flexibility*.

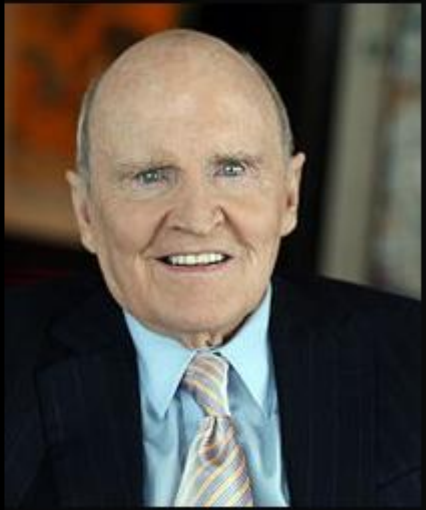
- Strategic flexibility is based on the premise that understanding and managing total compensation in a global business shifts thinking away from using a balance sheet to keep expatriates economically whole or relying on stereotypical notions of differences among nations. The focus, rather, is on understanding and leveraging differences within and between nations.

- There are two varied approaches to compensation – Balance Sheet Approach and Going Rate Approach.

- The Balance Sheet Approach is the most commonly used approach with the primary objective of keeping the home country standard of living while providing a financial inducement for expatriates.

- The Going Rate Approach is primarily based on the local market rates. It relies heavily on survey comparisons among local nationals, expatriates of the same nationality and expatriates of all nationalities.

- A constant challenge for companies operating internationally is the need to balance providing remuneration packages competitive enough to attract the right people to meet company objectives with keeping costs down, particularly in the current economic climate.



If you pick the right people and give them the opportunity to spread their wings and put compensation as a carrier behind it you almost don't have to manage them.

(Jack Welch)