

Week 12 & 13

Compensation

Chapter Objectives

- Examine the complexities that arise when firms move from compensation at the domestic level to compensation in an international context.
- Detail the key components of international compensation.
- Outline the two main approaches to international compensation and the advantages and disadvantages of each approach.
- Examine the special problem areas of taxation, valid international living cost data and the problem of managing TCN compensation.
- Examine the recent developments and global compensation issues.

Introduction

- Global compensation managers increasingly deal with two areas of focus.
 - They must manage highly complex and turbulent local details, while
 - Concurrently building and maintaining a unified, strategic pattern of compensation policies, practices and values.

Requirements for Successful Compensation and Benefits

- Knowledge of employment and taxation law, customs, environment and employment practices of many foreign countries
- Familiarity with currency fluctuations and the effect of inflation on compensation, and
- A good understanding of why and when special allowances must be supplied and which allowances are necessary in what countries

All within the context of shifting political, economic and social conditions.

Objectives of International Compensation

- ❑ Should be consistent with the overall strategy, structure and business needs of the multinational.
- ❑ Must work to attract and retain staff in the areas where the multinational has the greatest needs and opportunities, hence must be competitive and recognize factors such as incentive for foreign service, tax equalization and reimbursement for reasonable costs.
- ❑ Should facilitate the transfer of international employees in the most cost-effective manner for the firm.
- ❑ Must give due consideration to equity and ease of administration.

Expatriate Expectations

- Financial protection in terms of benefits, social security and living costs in the foreign location.
- Opportunities for financial advancement through income and/or savings.
- Issues such as housing, education of children and recreation to be addressed in the policy.
- Career advancement and repatriation.

Key Components of International Compensation

The area of international compensation is complex, primarily because multinationals must cater to three categories of employees:

- PCNs, TCNs and HCNs
- Key Components:
 - ❖ Base salary
 - ❖ Foreign services inducement
 - ❖ Hardship premium
 - ❖ Allowances
 - ❖ Benefits

Base Salary

- In a domestic context, base salary denotes the amount of cash compensation serving as a benchmark for other compensation elements (such as bonuses and benefits).
- For expatriates, many allowances are directly related to base salary (e.g. foreign service premium, cost-of-living allowance, housing allowance)
- It is the basis for in-service benefits and pension contributions – 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.

Foreign Service Inducement and 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.
 - The definition of hardship, eligibility for the premium and amount and timing of payment must be addressed.
 - In cases in which hardship is determined, U.S. firms often refer to the U.S. Department of State's *Hardship Post Differentials Guidelines* to determine an appropriate level of payment.
- Foreign service inducements are usually made in the form of a percentage of salary, 5-40% of base pay.
 - Such payments vary, depending upon the assignment, actual hardship, tax consequences and length of assignment.
- More commonly paid to PCNs than to TCNs.

Allowances

- Multinationals generally pay allowances in order to encourage employees to take international assignments and to keep employees ‘whole’ relative to home standards.
- Establishing an overall compensation policy can be very challenging, partly because of the various forms of allowances, such as:
 - Cost-of-living allowance
 - Housing allowance
 - Relocation allowance
 - Education allowance
 - Home leave allowance
 - Hardship allowance

Cost-of-living Allowances (COLA)

- COLA receives the most attention, to compensate for differences in expenditures between the home country and the foreign country (e.g., to account for inflation differentials, currency fluctuations, etc.).
- The COLA may also include payments for housing and utilities, personal income tax or discretionary items.
- The provision of a housing allowance implies that employees should be entitled to maintain their home-country living standards (or, in some cases, receive accommodation that is equivalent to that provided for similar foreign employees and peers).
- International comparison of cost of living is difficult and can be problematic.

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.
 - Allowances regarding perquisites (cars, club memberships, servants and so on) may also need to be considered (usually for more senior positions, but this varies according to location).
 - These allowances are often contingent upon tax-equalization policies and practices in both the home and the host countries.

Education Allowances

- Expatriates' children are an integral part of any international compensation policy.
 - Allowances for education can cover items such as tuition, language class tuition, enrolment fees, books and supplies, transportation, room and board and uniforms.
 - PCNs and TCNs usually receive the same treatment concerning educational expenses.

Allowances for Spouse Assistance

- To help guard against or offset income lost by an expatriate's spouse as a result of relocating abroad.
 - Some firms may pay an allowance to make up for a spouse's lost income.
 - U.S. firms are beginning to focus on providing spouses with employment opportunities abroad, either by offering job-search assistance or employment in the firm's foreign office (subject to a work visa being available).

Alternative Allowances

- Housing alternatives may include:
 - Company-provided housing, either mandatory or optional
 - A fixed housing allowance
 - Or assessment of a portion of income, out of which actual housing costs are paid.
- Home leave alternatives:
 - Allow foreign travel rather than returning home
 - Expatriates may become more homesick than others who return home for a ‘reality check’ with fellow employees and friends.
- As a firm internationalizes, formal policies become more necessary and efficient.

Benefits

- In addition to the already discussed benefits, multinationals also provide vacations and special leave.
 - Annual home leave usually provides airfares for families to return to their home countries.
 - Rest and rehabilitation leave, based on the conditions of the host country, may provide the employee's family with airfares to a more comfortable location near the host country.
 - Emergency provisions are available in case of a death or illness in the family.
 - Employees in hardship locations often receive additional leave expense payments or rest and rehabilitation periods.

Issues Concerning Benefits

- Very difficult to deal with country-to-country, as national practices vary considerably:
 - Transportability of pension plans
 - Medical coverage
 - Social security benefits
- Firms need to address many issues, including:
 - Whether or not to maintain expatriates in **home-country benefit 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.

Issues Concerning Benefits *(cont.)*

- Laws governing private benefit practices differ from country to country, and firm practices also vary.
- In some countries, expatriates cannot opt out of local social security programs. In such circumstances, the firm normally pays for these additional costs.
 - European PCNs and TCNs enjoy portable social security benefits within the European Union.
- Multinationals have generally done a good job of planning for the retirement needs of their PCNs, but this is generally less the case for TCNs.

Approaches to International Compensation

There are two main options in the area of international compensation

- ***Going Rate Approach*** (also referred to as the Market Rate Approach)
- ***Balance Sheet Approach*** (also known as the Build-up Approach).

Going Rate Approach

- Based on local market rates
- Relies on survey comparisons among
 - Local nationals (HCNs)
 - Expatriates of same nationality
 - Expatriates of all nationalities
- Compensation based on the selected survey comparison
- Base pay and benefits may be supplemented by additional payments for low-pay countries.

Advantages and Disadvantages of the Going Rate Approach

- Advantages

- Equity with local nationals
- Simplicity
- Identification with host country
- Equity among different nationalities

- Disadvantages

- Variation between assignments for same employee
- Variation between expatriates of same nationality in different countries
- Potential re-entry problems

The Balance Sheet Approach

- The basic objective is to ‘keep the expatriate whole’ through maintenance of home-country living standard plus a financial inducement to make the package attractive.
 - Home-country pay and benefits are the foundations of this approach
 - Adjustments to home package to balance additional expenditure in host country
 - Financial incentives (e.g., expatriate/hardship premium) added to make the package attractive
 - Most common system in usage by multinationals

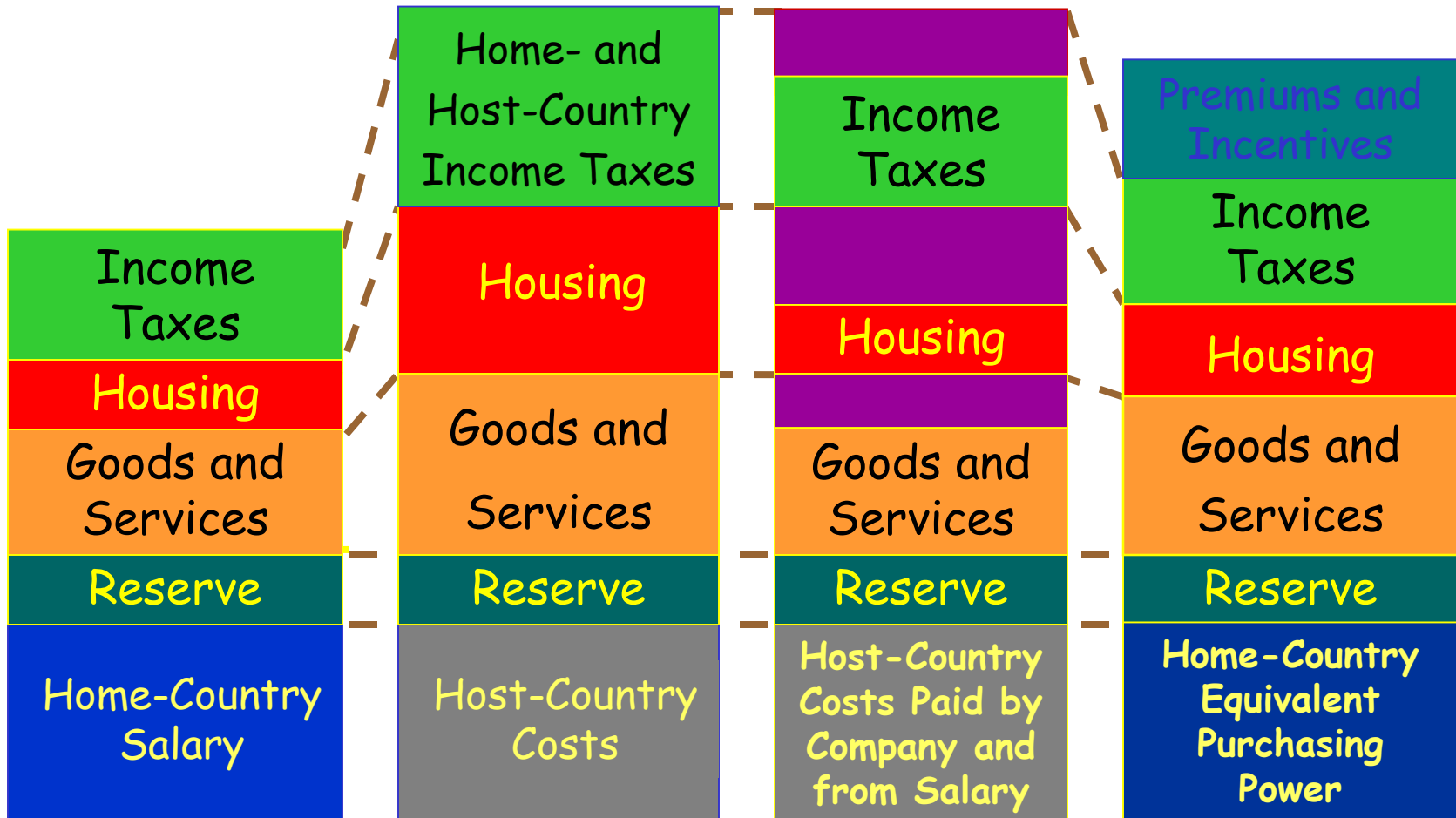
Major Categories Incorporated in the **Balance Sheet Approach**

(cont.)

- **Goods and services**
 - Home-country outlays for items such as food, personal care, clothing, household furnishings, recreation, transportation, and medical care.
- **Housing**
 - Major costs associated with housing in the host country.
- **Income taxes**
 - Parent-country and host-country income taxes.
- **Reserve**
 - Contributions to savings, payments for benefits, pension contributions, investments, education expenses, social security taxes, etc.

A Typical Balance Sheet

Additional Costs Paid by Company



Expatriate Compensation Worksheet

Employee	Brian Smith		
Position	Marketing Manager		
Country	New Euphoria		
Reason for change	New Assignment		
Effective date of change	1 February 2004		
<i>Item</i>	<i>Amount A\$ p.a.</i>	<i>Paid in Australian dollars A\$ p.a.</i>	<i>Paid in local currency NE\$ p.a.</i>
Base salary	155 000	77 500	116 250
Cost of living allowance	38 800		58 200
Overseas service premium (20%)	36 400	36 400	
Hardship allowance (20%)	36 400	36 400	
Housing deduction (7%)	- 10 850	- 10 850	
Tax deduction	- 75 175	- 75 175	
TOTAL	180 575	64 275	174 450
COLA Index – 150			
Exchange rate – 1.5	Authorized/Date		

Example of an Expatriate Compensation

- An expatriate working in a U.S. branch may receive:
 - Base pay: \$1,400/mon
 - Housing: up to \$1,400/mon (Optional)
 - Itemized reimbursement: \$500/mon
 - Discretionary expense (e.g., gifts & gratuity to clients and partners): \$1000/special holidays
 - Benefits: Social security/Medicare (Optional)
 - Health care: \$200/mon paid by employer
 - Unemployment coverage
 - Workers comp

An U.S. Expatriate Compensation

- A U.S. expatriate working for a Chinese university:
 - Base pay variation: \$1,500-\$10,000/mon
 - Housing: Free for initial 6 months or up to a lump sum subsidy of \$1,500-10,000 for a contract of 3 years or above (optional)
 - Benefits: Pension coverage for a 5 year contract or paid at the option of the expatriate
 - Health care: Completely paid by employer or optional incentive to the expatriate
 - Home leave 1-2 times/Yr
 - Paid vacations and observed Chinese holidays
 - Initial research launch grant: \$10,000

Advantages and Disadvantages of the Balance Sheet Approach

- Advantages:

- Equity
 - Between assignments
 - Between expatriates of the same nationality
- Facilitate re-entry
- Easy to communicate to employees

- Disadvantages:

- Can result in great disparities
 - Between expatriates of different nationalities
 - Between expatriates and local nationals
- Can be complex to administer
- May entail difficulty to attract human capital

Taxation

- This aspect of international compensation probably causes the most concern to HR practitioners and expatriates (both PCNs and TCNs), as taxation generally evokes emotional responses. **No one enjoys paying taxes**, and this issue can be very time consuming for both the firm and the expatriate.
- An assignment abroad can mean that a U.S. expatriate is taxed both in the country of assignment and in the USA. This **dual tax** cost, combined with all of the other expatriate costs, makes some U.S. multinationals think twice about making use of expatriates.

Approaches to Handling International Taxation:

- *Tax Equalization*
 - Firms withhold an amount equal to the home-country tax obligation of the PCN, 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 compensation 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.

Tax Equalization

- By far the more common taxation policy used by multinationals.
 - For a PCN, tax payments equal to the liability of a home-country taxpayer with the same income and family status are imposed on the employee's salary and bonus.
 - Any additional premiums or allowances are typically paid by the firm, tax-free to the employee.
- As multinationals operate in more and more countries, they are subject to widely discrepant income tax rates.
- Just focusing on **income tax** can be misleading, as the shares of both personal and **corporate taxes** are rising in the OECD countries.

Diversity in National Taxation

- If we look at total tax revenues as a percentage of GDP, the **“top five” highest taxation countries** are:
 - Sweden, Denmark, Finland, France and Belgium
 - The United States is 25th with the other large advanced economies towards the bottom of the list
 - Japan, 26th; Britain, 16th; and Germany, 12th.
- International accounting firms may provide advice and prepare host-country and home-country tax returns for their expatriates.
- Increasingly, firms are also outsourcing the provisions of further aspects of the total expatriate compensation packages including a variety of destination services in lieu of providing payment in a package.

Approaches to International Compensation

- Multinationals need to consider the extent to which specific practices can be modified in each country to provide the most tax-effective, appropriate rewards for PCNs, HCNs and TCNs within the framework of the overall compensation policy of the firm.
- The difficulties in international compensation “are not compensation so much as benefits”:
 - Pension plans are very difficult to compare or equalize across nations, as cultural practices vary endlessly.
 - Transportability of pension plans, medical coverage and social security benefits are very difficult to normalize.

Issues Concerning Benefits

- Companies need to address whether or not to maintain expatriates in home-country programs, particularly if the company does not receive a tax deduction for it.
 - Whether companies have the option of enrolling expatriates in host-country benefit programs and/or making up any difference in coverage.
 - Whether host-country legislation regarding termination affects benefit entitlement.
 - Whether expatriates should receive home-country or host-country social security benefits.
 - Whether benefits should be maintained on a home-country or host-country basis, who is responsible for the cost.
 - Whether other benefits should be used to offset any shortfall in coverage and whether home-country benefit programs should be exported to local nationals in foreign countries.

International Costs of Living

- Multinationals using the Balance Sheet Approach must constantly update compensation packages with new data on living costs, which is an on-going administrative requirement.
- Must also be able to respond to unexpected events, such as the currency and stock market crash, which suddenly unfolded in a number of Asian countries in late 1997.
- The level of local knowledge requires specialist advice.

- A recent survey of living costs ranked the 10 most expensive cities as:
 - Tokyo
 - Moscow
 - Osaka
 - Hong Kong
 - Beijing
 - Geneva
 - London
 - Seoul
 - Zurich
 - New York

A Wider View on *Business Costs*

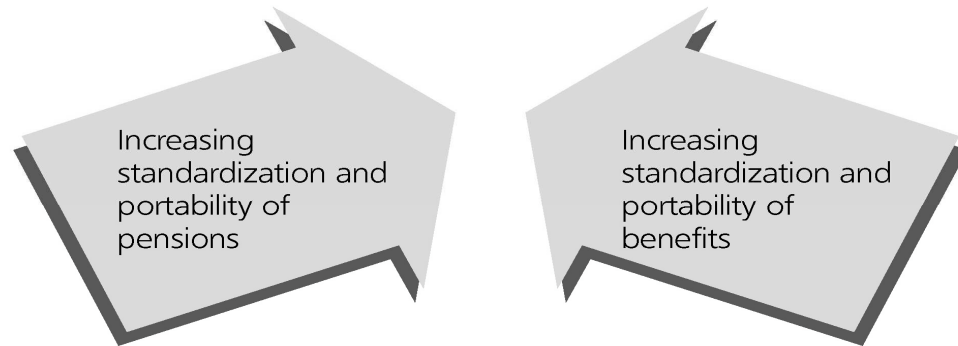
- Relate costs of doing business in different economies to statistical measures of:
 - Wages
 - Costs for expatriate staff
 - Air travel and subsistence
 - Corporation taxes
 - Perceived corruption levels
 - Office and industrial rents
 - Road transport.
- Generally the developed countries tend to rank as more expensive than developing countries because their wage costs are higher, but nothing is absolute.

Some Tentative Conclusions: Patterns in Complexity

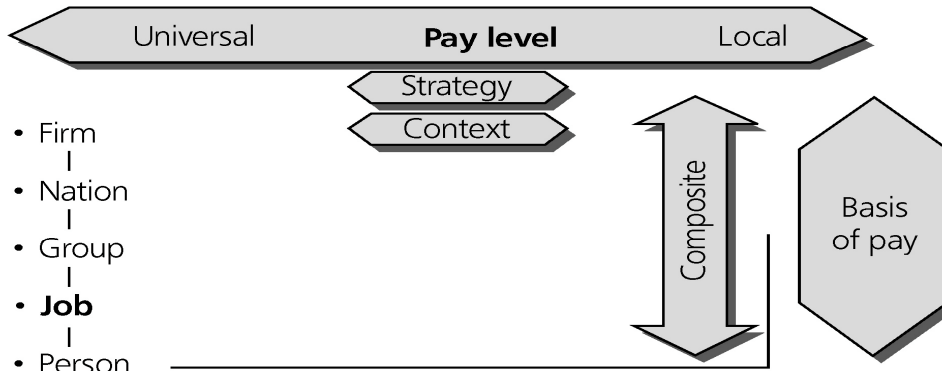
- It may be that international compensation administration is more complex than its domestic counterpart, but not radically different in pattern or form.
- Recent developments in the study of global pay issues may be seen to operate at three distinct levels:
 - The basic level of cultural values and assumptions;
 - The level of pay strategy, practices and systems design;
 - The level of pay administration and form.

Patterns for International Pay

Level 3:
Pay forms and administration



Level 2:
Pay strategy, practices and systems



Level 1:
Pay norms and assumptions



- Firm
- Nation
- Group
- **Job**
- Person

Some Tentative Conclusions: Patterns in Complexity *(cont.)*

- At the level of cultural values, a debate is ongoing between
 - Advocates of pay systems that value competitive individualism and result in ‘hierarchical’ pay systems with large pay differentials for executives, market-sensitive professions and other ‘critical’ employee groups, and
 - Advocates of pay systems that value cooperative collectivism and result in more ‘egalitarian’ pay systems with smaller pay differentials and more shared group or firm-wide reward practices.

Summary

- In this chapter, we have examined the complexities arising when firms move from compensation at the domestic level to compensation in an international context.
- It is evident from our review that compensation policy becomes a much less precise process than is the case in the domestic HR context.
- To demonstrate this complexity, we have:

Summary *(cont.)*

- Detailed the **key components** of an international compensation program.
- Outlined the **two main approaches** to international compensation (the Going Rate and the Balance Sheet) and contrasted the advantages and disadvantages of each approach.
- Outlined **special problem areas** such as taxation, obtaining valid international living costs data, and the problems of managing TCN compensation.
- Presented a model of global pay that highlights the complexity and yet familiarity of pay practices in the global context.
- The combination of pay decisions based on strategic global standardization and sensitivity to changing local and regional conditions that characterizes the state of international pay practices.

Implications for IHRM

- Providing a strategic yet sensitive balance can only be achieved by creating and maintaining professional networks, comprised of home office and local affiliate HR practitioners, outsourcing selected activities through specialist consultants, and a close cooperation with local and regional governments and other key local institutions.