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Expatriate compensation

An exploratory review of salient contextual factors and common practices

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Abstract

Purpose – This study aims to examine important situational factors impacting expatriate compensation and common practices utilized in compensating expatriates.

Design/methodology/approach – A synthesis of literature was reviewed, leading to the identification of numerous situational or contextual factors impacting expatriate compensation. A review of extant literature also identified several customary approaches to expatriate compensation.

Findings – A variety of factors can directly affect expatriate compensation, with three primary approaches an organization should consider. These factors include host-country cost of living, housing, dependent education, tax implications and health care – factors most often incorporated as a component of one of the primary approaches to compensation discussions: destination-based approach, the balance-sheet approach, and the international headquarters approach.

Practical implications – This article was intended to enhance understanding of expatriate compensation by collectively examining not only the "how" (primary approaches) but also the "why" (salient contextual or situation factors) firms should consider when determining how to assemble an appropriate package.

Originality/value – Presenting the factors and practices together makes an important contribution to the literature on expatriate compensation by addressing not only the "how" (customary approaches) of expatriate compensation, but also the "why" (salient contextual factors).

Keywords Expatriates, Remuneration, Pay

Paper type Conceptual paper

The globalization of our world economy has evolved significantly over recent decades as organizations have sought opportunities to perpetuate and remain competitive (Lowe *et al.*, 2002). One of the most obvious implications has been the tremendous increase in the number of US workers who are being transferred to foreign countries. In fact, current estimates suggest that over two million Americans are working abroad for US companies at any given time (McCallum and Olson, 2004; Peterson *et al.*, 1996). Previously, being sent on an overseas assignment was an indicator of a career in decline. Currently, however, many organizations, particularly larger multinational corporations (MNCs), consider an overseas assignment a prerequisite for advancing one's career (Chen *et al.*, 2002; Ioannou, 1995).

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The use of expatriate employees by organizations in their foreign subsidiaries represents a substantial investment with costs of expatriate failure reaching exorbitant levels (Baruch, 2004). Specifically, recent estimates suggest that each expatriate failure, a premature departure, can cost an organization in excess of $1 million (Insch and Daniels, 2002; Wentland, 2003). Taken in aggregate, expatriate failure costs US firms approximately $2 billion per year (Punnett, 1997).

One of the issues that organizations have to address when considering this failure rate is the role that compensation plays in the whole expatriate dynamic (Baruch, 2004). From an operational perspective, many organizations have adjusted or entirely revamped expatriate compensation (Phillips and Fox, 2003). Organizations quickly discovered that compensation is among the most important factors a prospective expatriate considers when accepting an overseas assignment (Baruch, 2004). In today's intensely competitive labor market attracting and retaining the best and brightest professionals is the lifeblood of any successful organization with global operations. Further, experienced expatriates are more valuable than ever as organizations continue to extend their global markets. This is crucial since organizations need expatriates who can lead the charge as they seek out new global clients and new revenue streams (Dwyer, 1999; Sims and Schraeder, 2004; Zingheim and Schuster, 2001).

A lack of expatriate professionals who know the business and are motivated to perform at the highest level could result in companies not being able to compete adequately in emerging foreign markets. Further, compensation of expatriates is regarded as a key component in the effectiveness of global operations (Lowe *et al.*, 2002). This reinforces why it is imperative for organizations to effectively compensate expatriates, regardless of location (Dwyer, 1999; Freedman and Vardy, 1998). In regard to compensation, average pay can range depending on a number of factors. Higher packages can range from $300,000 to $1 million per year (Wentland, 2003).

To gain a better understanding of pertinent issues related to expatriate compensation, leaders of global organizations need to be aware of several important contextual factors impacting expatriate compensation. More specifically, they should be aware of key factors an organization should consider when compensating expatriates. They should also be cognizant of the commonly used approaches parent organizations utilize to determine the appropriate levels of expatriate compensation. Baruch (2004, p. 220) aptly stated that "... while general guidelines should lead to a 'fair' and constructive system, situational factors will force companies to be inventive and flexible in setting and managing the remuneration system across borders".

The present study was designed, in part, to address these two important considerations by looking at the "how" and "why" of expatriate compensation. The primary purposes of this study were to identify key factors that should be considered when developing expatriate compensation plans and to identify approaches to expatriate compensation that are most prevalent amongst organizations relying heavily on the use of expatriates in their foreign operations.

Expatriate compensation: a closer look at the fundamental issues

Expatriate compensation has long been a source of frustration for organizations. Despite efforts to develop effective expatriate compensation plans, many organizations simply do not obtain the "return on investment" they expect from their plans. Some organizations may have dual and often conflicting goals with respect to expatriate compensation systems. For example, on one hand, the organization must seek to control the escalating costs often associated with expatriate compensation packages. However, on the other hand, the organization must be equitable to their current expatriates, while ensuring the organization offers a compensation package competitive enough to attract, retain, and motivate expatriates. Addressing this dilemma often requires a very complicated balancing act for organizations (Cryne, 2004; Gould, 1999). Yet, in order to attract, retain, and motivate qualified expatriates, organizations must find this coveted balance in order to remain competitive in their foreign operations.

This contention is supported by Dwyer's (1999) research arguing that without expatriate professionals who know the business, professionals who are motivated to perform at the highest level, companies may not be able to compete adequately in distant markets. According to Dwyer, expatriate compensation packages are a key requirement for accomplishing success in the foreign operation. Wentland's (2003) research tends to support Dwyer's work in that Wentland focuses on the importance of the selection process in maintaining the viability of an organization's foreign operations. Again, this leads to a variety of pertinent questions that must be considered. Specifically: what factors affect how expatriate compensation is determined? How does the parent organization, in effect, keep the employee whole? How do local market conditions in the host country affect expatriate compensation? There are numerous factors to consider when developing expatriate compensation plans and many organizations are simply not "getting it right" as suggested by a number of studies (e.g. Chen *et al.*, 2002; Wentland, 2003). Some of the most prominent contextual or situational factors identified from a synthesis of related literature are summarized below.

Salient contextual factors affecting expatriate compensation

Ask any international human resource executive about the goal of expatriate compensation packages and they will probably use the word "whole" or the concept of wholeness in their answer: "To keep employees whole" (Oemig, 1999, p. 40). "Wholeness" may mean different things to different groups. In general, however, the concept of wholeness refers to the organization's desire to ensure that the expatriate does not experience an overt gain or loss when all elements of the compensation package are combined (Wentland, 2003). From the expatriate's perspective, however, wholeness may embody their desire to avoid spending a dollar more while abroad than they would at home for any given expense category. Expatriates may even take the concept of wholeness a step further by expecting some type of "hardship" or incentive pay for accepting the expatriate assignment (Oemig, 1999; Wentland, 2003). This may result in a dilemma – the organization's conceptualization of wholeness may not be congruent with the expatriate's expectations (Oemig, 1999; Wentland, 2003).

How, exactly, does an organization accomplish "wholeness" considering the fact that many expatriates may be in locations characterized by a deficiency in infrastructure, modern conveniences, schools for children, shopping facilities, and even adequate healthcare? Even those expatriates located in developed countries may not be "whole" (or, perhaps even more importantly, perceive themselves as being kept whole) if simply provided their traditional compensation packages (Oemig, 1999; Wentland, 2003).

As a result, many organizations find themselves in the position of having to offer expatriates a variety of alternative compensation elements in order to maintain their sense of "wholeness." The following sections will more closely examine the primary factors associated with "wholeness" within the context of expatriate compensation.

Host country market cost of living

A key factor that has an impact on expatriate compensation is the consideration (by the parent organization) of local markets in the host country. Research indicates that perhaps no other variable has a greater impact on expatriate compensation (relative to the home country's compensation system and market) than the cost of living in the host country (Frazee, 1998b; Overman, 2000). The vast majority of firms (some 92 percent of firms included in a frequently cited study conducted by Price Waterhouse in 1996 of 370 firms that utilized expatriate employees) consider the cost of living in the host country when computing expatriate compensation (Frazee, 1998b). Generally, employers use a "no loss" approach when developing compensation packages. Within this framework, expatriate compensation is adjusted upward for higher costs of living, but is not adjusted downward if the cost of living in the host country is less than the home country (Frazee, 1998b; Overman, 2000).

Typically the parent organization will consider several additional factors when computing the anticipated cost of living. Housing, children's education, and healthcare costs will be discussed in detail in subsequent sections and, therefore, will not be discussed as "market costs." Consideration of the local markets (often referred to as host country cost of living) usually involves an analysis of the cost of goods and services in the host country. The analysis, particularly for an organization with expatriates in multiple countries, may be conducted by an independent consulting firm (Solomon, 1995). Cost of living adjustments are usually added as a percentage increase to the expatriate's base pay.

Adjusting expatriates' pay based on market costs in the host country may vary widely. For example, a cost of living adjustment in Japan, where gasoline prices are in the five to six dollar range per gallon and where just about everything costs more than in the USA, would be substantial. A recent estimate in one study for a "goods and services allowance" for Japan was an additional 50 percent added to base pay – the highest of any country. Hong Kong was the second highest with approximately 30 percent being added to the expatriate's base pay, and Mexico a close third having just under 30 percent added to base pay in the form of a goods and services allowance (Aschkenasy, 1997). The cost of living adjustment for an expatriate located in a developing country, with a very low cost of living, may be substantially less than the estimates associated with prior examples (Solomon, 1995).

In general, prospective expatriates have come to expect that employers will consider local markets and the prices of goods and services in the host country when developing expatriate compensation packages (Wentland, 2003). Also, expatriates expect the parent company to adjust the company package (relative to the firm's US compensation system) to reflect any additional cost of living, thereby keeping the expatriate "whole" or in some cases, more than whole (Oemig, 1999).

While many expatriates consider local market adjustments to be "only fair" and a simple matter of preventing any erosion of their purchasing power, local market adjustments added to expatriates' home country salaries may represent huge incremental costs and may become a substantial financial burden to the parent organization. Local market cost of living adjustments are one of the primary reasons why some firms are attempting to reduce the number of their expatriates by "going local." Also, organizations are experimenting with a very different approach to expatriate compensation, referred to as "destination-based."

Health care

According to research by Frazee (1998a), healthcare is one of the primary concerns of expatriates yet it has been largely neglected by researchers. Frazee's research indicates that only 65 percent of international placements are satisfied with the healthcare service they receive under their current expatriate compensation benefits package. Fully a third claimed that the plans provided by their employer, while on foreign assignment, were inadequate resulting in the expatriate not receiving adequate and timely treatment for illness or injury. In some cases the chief complaint was an "unreal bureaucracy" to process claims for treatment in the host country (Frazee, 1998a).

Often, due to US carrier liability restrictions, the home organization may have a separate insurer for expatriates. Say, for example, the insurer is French but the expatriates are located in Hong Kong. Claims, written in Chinese and itemized in Hong Kong currency are sent to the French insurer who may be unaccustomed to dealing with this kind of paperwork. The result may be a situation in which the documents must be translated and the currency converted (incidentally, currency exchange rates may fluctuate in the interim) extending the reimbursement process for months, if not longer (Frazee, 1998a).

Traditional approaches to providing expatriates with healthcare benefits are slowly changing. Some organizations are contracting with insurance companies that offer special plans tailored to the needs of expatriates, such as Cigna and Aetna. These insurers have processes in place to handle language translation and even remove the risk of currency fluctuation. Expatriate claims may be handled internally or outsourced. The result can be that expatriate claims are paid in ten to 15 days, compared to months or even more than a year. Of course, these types of insurance plans, tailored to expatriates and organizations utilizing expatriates, are generally more expensive than a comparable plan for home based employees. However, many organizations feel that they have little choice regarding the provision of these costly insurance plans in an effort to keep their expatriates whole (Frazee, 1998a). Moreover, healthcare is such a critical part of any employee's compensation plan that parent organizations have discovered, particularly when it comes to expatriate healthcare, that a policy causing the least disruption is often prudent (Oemig, 1999).

Housing

A housing allowance or even free housing is often a critical component of an expatriate compensation package (Wentland, 2003). In one study, research indicated that close to a third of organizations provided completely free housing to their expatriates (Gould, 1997; Wentland, 2003). Depending on the nature of the country of assignment, comparable housing for the expatriate may not be available. This could be the case regardless of the level of economic development of the host country. For example, an expatriate family who leaves their 2400 square foot split-level house on a quiet "cul-de-sac" may be quite shocked when they are moved into the company provided

1,200 square foot apartment in Tokyo (Oemig, 1999). Conversely, in some less-developed countries, the housing available for expatriates may exceed the expectations of expatriates (Oemig, 1999). Expatriates often congregate in what have been referred to as "expatriate ghettos." These are hardly ghettos, however. Instead, they are isolated upper-class communities in which there may be little or no contact with host country nationals (HCNs) (Frazee, 1998b). One would find examples of such communities in Saudi Arabia.

Realizing that adequate housing is a crucial factor in successful expatriate adjustment, many organizations continue to assist the expatriate by both locating and subsidizing housing. Many organizations, as well as their expatriates, continue to view housing assistance as a key part of the expatriate compensation package (Oemig, 1999).

Foreign taxes

Another important factor that often affects expatriate compensation is the issue of dual taxation (Swaak, 1995; Wentland, 2003). Without assistance from the parent company, the expatriate may be in a situation where they pay their US taxes and the taxes imposed by the government of the host country since US expatriates are required to pay taxes on their worldwide income (McCallum and Olson, 2004). There may be an array of additional taxes in the host country. These could include significant income and sales taxes, plus unexpected taxes such as excise taxes on imported goods. If an expatriate and family must ship their household items, including an automobile, excise taxes have the potential to be quite high. Often, however, the parent company may cover much, if not all, of this additional tax burden (Kates and Spielman, 1995; Phillips and Fox, 2003). This element of expatriate compensation is often referred to as tax equalization or tax protection (Phillips and Fox, 2003).

The US Internal Revenue Service does permit a deduction of up to $70,000 on foreign earned income (when certain time in host country requirements are met). However, it is not uncommon for managerial level expatriates to earn more than $70,000, thus being assessed two tax bills (Hodgetts and Luthans, 1993). As previously mentioned, parent organizations may offer to pay any extra tax burdens. The goal, however, is not to relieve the expatriate of any and all tax burdens. Most organizations calculate the difference by determining the base salary and other extras (such as bonuses) that the expatriate would earn if based in the home country. The taxes on this income are then computed and compared with the taxes due on the expatriate's income. Any taxes exceeding what would have been imposed in the home country are paid by the parent organization. Any windfall (due to the $70,000 US income tax exclusion on this amount of foreign earned income, for example) is usually kept by the expatriate as a reward for taking the assignment (Hodgetts and Luthans, 1993; Phillips and Fox, 2003).

Children's education

Another factor impacting expatriate compensation is the inclusion of an education allowance, or even free education for the children of expatriates. Many organizations employing expatriates have realized that numerous and complex family issues are involved in an expatriate assignment, including uprooting children from schools. Traditionally, the company has footed the bill for children's schooling at an international school that can provide some form of continuity in curriculum and language. While the cost associated with such an international school may be somewhat high, parent organizations have realized that "paying up" in these situations is a virtual requirement. Generally, expatriates today are urged to be more flexible as parent organizations seek to reduce their expatriate costs, but some aspects of the expatriate assignment fall into the non-negotiable category. Typically, childrens' education comes under the "non-negotiable" category (Allard, 1996).

Ultimately, when the parent company covers the cost of adequate education for expatriate children, it makes it easier for the children to reassimilate into the home country school system once the expatriate assignment is complete (Allard, 1996). As previously mentioned, including an allowance for, or paying entirely, the cost of children's education is often viewed by expatriates as a critical part of their compensation package (Allard, 1996).

Common approaches to developing expatriate compensation packages

The previous sections have been primarily devoted to reviewing the literature concerning the specific factors affecting expatriate compensation. An improved understanding of salient issues associated with expatriate compensation should not be limited, exclusively, to these factors. Specifically, attention should also be given to approaches commonly utilized by organizations in compensating their expatriates. Consequently, the following section is devoted to examining the different approaches to expatriate compensation.

The balance-sheet approach

One of the most pervasive approaches to compensating expatriates is the balance sheet approach. Research suggests that more than 85 percent of US organizations employing expatriates use the balance sheet approach (Overman, 2000; Wentland, 2003). In a 1996 study commissioned by Price Waterhouse, the figure for usage of the balance sheet approach exceeded 90 percent (Frazee, 1998b). While there is some variation in the use of this approach, experts agree that the balance sheet method remains the method of choice for US-based organizations employing expatriates (Frazee, 1998b).

In addition to being the most common approach to expatriate compensation, the balance sheet method is among the oldest approaches to compensating expatriates. The balance sheet approach was designed soon after World War II as a no gain-no loss method of compensating employees for working overseas. The idea was that the employer would sustain the expatriate employee's standard of living throughout the assignment so that the expatriate family did not come out ahead or behind (financially) from the assignment. In general, the goal of the balance sheet approach is to "provide equivalent purchasing power abroad to help maintain home lifestyle" (Overman, 2000, p. 88).

When parent organizations utilize the balance sheet approach, it is essential to keep expatriate salaries in line with their home country peers, not with host country colleagues. In other words, the focus is on maintaining internal equity with peers in the home country (Reynolds, 2000). Under the balance sheet approach, an expatriate would typically be responsible for the same costs and expenses as a domestic counterpart with the parent company paying additional income in an effort to keep the employee whole. As a final note, it is important to recognize that there are numerous versions of the balance sheet approach.

The destination-based approach

As organizations seek to bring the spiraling costs of compensating expatriates under control, an increasingly popular approach to compensating expatriates has emerged. The "buzzwords" for this approach to compensating expatriates include "localization", "destination", and the "host country-based approach." This approach to expatriate compensation takes into account what competitors are paying and, more importantly, how expatriate compensation compares with the compensation levels of local employees in comparable jobs (Chen *et al.*, 2002; Mervosh, 1997; Wentland, 2003). Specifically, with the destination-based approach, traditional allowances (housing, children's education, and incentive premiums in particular) are sharply curtailed. The curtailing of incentive pay could be problematic given the perceived importance of performance-based pay to expatriates (Lowe *et al.*, 2002).

The destination-based approach is a marked shift away from the well-established balance sheet approach that has been so prevalent for the last five decades. The newer destination-based model endeavors to treat the expatriate employee as a citizen of the host country, encouraging a "when in Rome do as the Romans do" mentality whereby employees are expected to embrace their foreign lifestyle instead of living above it in an expatriate community (Myers, 1995).

Clearly, this approach to expatriate compensation has its disadvantages. The successful use of the destination-based approach is contingent on several factors, which may or may not be present in some organizations. First, organizations must understand that the most expensive expatriates are going to be those who least want to be in an overseas assignment. Therefore, for the destination-based approach to have any chance of being successful, it is generally accepted that an organization must have expatriate candidates who are motivated to seek foreign posts – employees who may be willing to forgo lavish allowances and benefits. By finding employees who want to work overseas and adhering to the destination model, it is estimated that organizations could save up to 20 percent of the cost of using the balance sheet approach (Myers, 1995).

Another requirement for success using the destination-based approach is to send a clear corporate message that an overseas stint is a virtual requirement for upward advancement in an organization. It is more and more common now that expatriates are being chosen from "high-potential" lists and told that accepting the transfer is a wise career move. Expatriates are recognizing that the experience abroad will translate into opportunities when they return to the USA. Some globally minded organizations are taking this a step further by making it a matter of formal policy that senior executives are chosen exclusively from among those with international experience (Oemig, 1999).

Another factor that may make the destination-based approach more effective is to ensure that expatriate employees clearly understand what will happen regarding their career upon repatriation into the home organization (Cryne, 2004; Eisenberger *et al.*, 1990; Misa and Fabricatore, 1979). Uncertainty about the nature of the position that will be available for the expatriate upon repatriation will decrease the effectiveness of the destination-based approach. Conversely, however, if the expatriate has the security of knowing how and to what position they will be repatriated (particularly if a successful overseas stint will be rewarded with a promotion), the destination-based approach may be quite effective (Arthur and Bennet, 1995).

Some organizations that have begun to implement the destination-based approach have been pleased with initial results and cost savings. Global companies like AT&T, Xerox Corporation, Mobil Corporation (pre-merger), and AlliedSignal have started to experiment with this approach. The key is to implement a destination-based expatriate compensation program slowly, selectively, and with a considerable amount of communication. Also, parent organizations must remember that regardless of which approach is used, certain basic needs of expatriates must be met. Even with a destination-based approach, organizations must be particularly sensitive to basic needs like security, medical care, education of children, housing, and home trips. Flexibility is key, since deciding exactly where to cut costs will depend on the nature of the assignment, the expatriate, and the expatriate's family (Myers, 1995).

The international headquarters approach

Under the international headquarters approach, also referred to as the "regional approach", expatriates are compensated as if all expatriate employees originated from the same geographic headquarters and are being paid on the same balance sheet program. For example, if an organization has expatriates from three or four different nationalities working together in Beijing, an international headquarters approach would ensure that these expatriates are not working under different compensation packages, thus promoting perceptions of equity. It also ensures, for example, that if two of the expatriates in Beijing accept a new assignment in Tokyo, they will not be paid any more or any less than the expatriates already working in Tokyo (Chen *et al.*, 2002; Frazee, 1998b). Gillette, a truly international company, has used this approach with considerable success when the company entered China (Zingheim and Schuster, 2001).

This type of approach can be somewhat complicated to administer, however. Since the goal is equity in a geographic location, the organization must find viable ways to manage social security, pension, and taxation laws across country borders (Allard, 1996). Another potential disadvantage of this approach is that, initially, this type of compensation package attracts younger expatriates. As these younger expatriates move up the corporate ladder and gain more experience, they begin to negotiate more traditional expatriate compensation packages – namely the home-based balance sheet approach. If they are unable to negotiate a compensation package they feel is consistent with their experience and position, they may simply move to a competitor (Allard, 1996).

Conclusion

It is clear that issues related to expatriate compensation can be quite complicated. There are a variety of factors that can directly affect expatriate compensation, with three primary approaches an organization should consider. It is also likely that, for some organizations, the answer to the difficult expatriate compensation decision may be "none of the above" – in that some organizations may not utilize the typical or most common approaches to expatriate compensation. Some organizations may mix and match, developing a hybrid-type system for compensating their expatriates using some type of cafeteria approach (Wentland, 2003) or other type of flexible plan (Burns, 2003) in an attempt to be "fair" (Baruch, 2004).

This article was intended to enhance our understanding of expatriate compensation by collectively examining not only the "how" (primary approaches) but also the "why" (salient contextual or situation factors) firms should consider when determining how to assemble an appropriate package. Given the implications of these considerations, it is apparent that the topic of expatriate compensation will be the focus of more research by the academic community, particularly with respect to systematic, empirical studies on expatriate compensation.

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