A New Practical Guide for Determining Expatriate Compensation: The Comprehensive Model

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A comprehensive approach to expatriate compensation begins with the selection process and an analysis of the desirability of the assignment.

Global organizations that use expatriates as part of their international managerial staffing strategy must confront the task of attracting the best candidates while being constrained by finite organizational resources that limit the compensation that can be provided. Because an expatriate compensation package can range from $300,000 to $1 million annually,1 and 25% of expatriates from the United States fail to adapt to their foreign assignment,2 a critical strategic-planning issue arises from expatriate assignments. Although it is true that many organizations have begun to examine and implement policies to reduce expatriate compensation, it is also true that expatriate compensation still represents a substantial cost for global organizations that opt to use expatriates, and expatriate failure rates continue to be high. Bridging the gap between containing compensation costs while increasing the probability of a successful expatriate assignment is an important key to unlocking an organization’s ability to compete on the world stage.

Bridging the Gap

Corporations in the United States developed an interested in expatriates and how to pay them shortly after World War II. In the early 1950s, few international personnel positions existed, and consequently, there were no truly effective compensation systems in place to handle the growing number of expatriates.3 During this period of time, the work of J. Frank Gaston, Joseph Brady, and other scholars helped to define the field of expatriate compensation.

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James E. Boyce and George Dickover shed light on this growing issue. Dickover suggested the notion of a balance sheet approach for compensating expatriates. This approach links the pay of an expatriate to pay in the home country and attempts to equalize the purchasing power between home-country executives and expatriates.

Today, most expatriate compensation strategies can be grouped into six general categories:
1. negotiation,
2. balance sheet,
3. localization,
4. lump sum,
5. cafeteria and
6. regional systems.

Negotiation is an ad hoc approach that is quite simple and allows an organization to reach individual agreements with each expatriate. Because of its simplicity, many human resources managers follow this approach. However, research indicates that the negotiation approach is time-consuming and develops too many compensation inconsistencies when an organization reaches approximately 20 expatriates.

The general goal of the balance sheet approach is to “make the expatriate whole.” That is, at a minimum, the expatriate should not suffer financially because of accepting an overseas assignment. Ideally, the compensation package should offer an incentive to offset any of the financial, personal and professional anxiety that is generally associated with accepting an overseas assignment. This compensation approach is particularly used for senior and midlevel expatriates who are being transferred from the parent company to a foreign subsidiary for a temporary assignment lasting between one and five years. It is not appropriate for permanent transfers to other countries, and it is not particularly useful when temporary assignments are extended indefinitely. The balance sheet approach provides two components of compensation: (a) base compensation and (b) incentive and equalization adjustments.

Base compensation includes salary, job performance incentives and indirect compensation or benefits. Issues involving salary center on the question of what should be used as the base salary. Many firms use the parent-country salary scale, whereas others use an international standard, a regional standard, a host-country scale, or a statistical mean of the salaries of other expatriates, peers or colleagues in the host location. The variety of salary possibilities can lead to inconsistencies in expatriate compensation packages and costly administrative-monitoring practices and policies.

The localization approach attempts to reduce the high costs of expatriate compensation by providing a compensation package that is in line with what local nationals are paid. The approach is generally used for expatriates who are just beginning their career and being sent on a long-term assignment. However, even under these conditions, the expatriate may be accustomed to a higher standard of living than experienced by local nationals. To correct this situation, some additional incentives need to be negotiated with the expatriate.

In the early 1960s, a lump-sum compensation approach was initiated by leading multinationals.
in response to the perception by some expatriates that the balance sheet compensation approach intrudes too heavily into the lifestyle decisions of the expatriate. Under the lump-sum approach, all the allowances and incentives normally paid under the balance sheet approach are combined into a lump sum and paid monthly with the base salary. The expatriate then is free to spend the lump sum on housing, transportation, travel, education and other needs.10

The cafeteria compensation approach is increasingly being used for upper-income or senior-level expatriates. Because these expatriates generally earn a high salary, the cafeteria compensation plan allows an expatriate to gain benefits such as a company car, club membership, insurance, company-provided housing and educational tuition without an increase in the expatriate’s income for tax purposes.11

The regional systems compensation approach applies when an expatriate makes a commitment to work within a particular region of the world. The exact compensation program that might be arranged can consist of any of the other compensation approaches already mentioned. The ultimate goal of a regional systems compensation approach is to maintain equity for the expatriate within that region of the world.12

Although numerous expatriate compensation strategies have been developed, the fact remains that both the cost of these compensation approaches and expatriate failure rates still remain relatively high.

Critical Limitations

Despite the development of several expatriate compensation strategies, global organizations that opt to use expatriates still lack a strategic-planning tool that can serve as a practical guide to reduce expatriate compensation costs and failure rates. This strategic-planning dilemma can be traced to two critical limitations of most of the existing expatriate compensation strategies. The first limitation is that none of the current expatriate compensation approaches focuses on the expatriate selection process and whether an employee is interested in and motivated to accept an expatriate assignment. The second limitation is that most of the existing expatriate compensation strategies do not consider the difficulty of the assignment. Only after these two critical limitations are accounted for can a comprehensive expatriate compensation model be developed.

Setting the Stage for a Guide

Without managers who know the business and are motivated to perform at the highest level, an organization may not be able to achieve its global strategic objectives.13 The motivational process begins with the selection of an expatriate. Current research tends to suggest that between 16% and 40% of all the American employees sent abroad return from their assignments early; a premature return may cost up to a $1 million.14 Implementing an effective selection process allows a company to evaluate the compatibility and receptiveness of an employee and his or her family to an assignment overseas.

A thorough selection process must be capable of developing a pool of qualified candidates for international positions. Ingo Theuerkauf developed a model that illustrates the stages of a thorough selection process. The stages include the following:

1. recruiting worldwide from the best local resources to build a broad base of young talent,
2. applying company-wide screening for international talent,
3. creating opportunities to gain substantial international experience and
4. promoting expatriates to senior-level positions at the corporate headquarters after completing their overseas assignment.15

Once a pool of qualified and willing expatriate candidates has been developed, the next step in the expatriate compensation process is to determine the desirability of a particular overseas assignment so that the appropriate compensation package can be implemented. Selection, assignment analysis and implementing an appropriate compensation package provide organizational decision makers and strategic planners with a methodology for determining what type of compensation package should be administered.

Another benefit of this compensation approach is that expatriate costs should be reduced. By establishing a selection process so that only employees who are interested in expatriate assignments are assigned to overseas positions, many of the costly incentives that are now necessary to encourage employees to accept an overseas assignment can be eliminated or reduced. Costly incentives will need to be paid only to employees who accept assignments in undesirable or questionable locations. By focusing on the expatriate selection process and evaluating the de-
sirability or lack of desirability of a foreign assignment, a new practical guide for determining expatriate compensation—a comprehensive model of expatriate compensation—can be developed.

Comprehensive Model
The foundation of the comprehensive model of expatriate compensation begins by using Theuerkauf’s selection process. The second stage of the model involves the assessment of the desirability of the expatriate assignment, which consists of analyzing the market attractiveness of the country, the risk associated with the country and the competitive advantage of the firm in that country. The market attractiveness of each country includes measures such as GDP per capita, population growth, income distribution, real purchasing power, unemployment rate, inflation rate and GDP growth rate.

The risk factor for each country focuses on political stability, economic stability (reliable fiscal and monetary policy) and legal restrictions on contract enforcement. The competitive advantage of the firm in a country examines issues such as whether the firm has prior business experience in the country, the demand for the firm’s products and the firm’s financial and human resources for that location. Through this evaluation process, expatriate assignments can be grouped into four situations: an ideal or desirable assignment, a question-mark assignment, a challenge assignment or an undesirable assignment.

Once the foreign assignment has been identified, the final step of the comprehensive model of expatriate compensation is to select the appropriate compensation package given the classification of the assignment. Because the selection portion of the model builds a reliable pool of employees willing to accept expatriate assignments, extra financial incentives need to be paid only for an undesirable foreign assignment or a question-mark scenario. An undesirable situation is when risk is high, market attractiveness is low and the competitive advantage of the firm is low. In this type of environment, the best compensation approach for the organization and the expatriate would be negotiation.

When market attractiveness, the competitive advantage of the firm and risk are high, this situation—the question-mark scenario—represents a considerable degree of risk for the expatriate because the political and/or economic stability of the country could have dramatic negative effects on business activity. Under this scenario, negotiation once again offers the best option for the firm and the expatriate.

The ideal or desirable expatriate assignment occurs when market attractiveness and the competitive advantage of the firm are high while risk is low. Under this scenario, the localization compensation approach should be used.

In the final expatriate employment situation—the challenge scenario—all three foreign assignment analysis factors are low. Because the overall political and economic environment of the country is stable under this scenario, the macroeconomic stage is set for an expatriate to focus on improving the competitiveness of the firm while also attempting to develop a target market within the country. Under this employment situation, the localization approach should serve as the base for compensating expatriates. In addition, sales, costs, customer service and other operational goals should be agreed on. The attainment of the operational goals should then be linked to a bonus plan for the expatriate—a localization with a “management by objectives” component. (See Exhibit 1.)

Conclusion
As more businesses expand internationally, an understanding of how to attract, retain and compensate expatriates while containing the associated costs can provide an organization with a competitive advantage in the global marketplace. The comprehensive model of expatriate compensation incorporates and combines an expatriate selection process with a detailed foreign assignment evaluation and links that situational analysis with a specific compensation package. The end result offers organizational strategic planners with a mechanism that balances the need to control expatriate costs while improving the probability of a successful assignment. By embedding the selection process within the model, the starting point for determining expatriate compensation is focused on recruiting and developing a pool of willing and able expatriates, which reduces the need to entice employees to accept foreign assignments with expensive compensation packages. Ultimately, the model should increase the effectiveness of an organization’s international operations.

Notes


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