

# Compensation of expatriates



**AN EXPATRIATE** An expatriate (in abbreviated form, expat) is a person temporarily or permanently residing in a country and culture other than that of the person's upbringing or legal residence. The word comes from the Latin *ex* (out of) and *patria* (country, fatherland). During the latter half of the 20th century expatriation was dominated by professionals sent by their employers to foreign subsidiaries or headquarters. Starting at the end of the 20th century globalization created a global market for skilled professionals and leveled the income of skilled professionals relative to cost of living while the income differences of the unskilled remained large.

Cost of intercontinental travel had become sufficiently low, such that employers not finding the skill in a local market could effectively turn to recruitment on a global scale. **BACKGROUND** Any major organization operating internationally could rely entirely on staff recruited locally. Most do so for the majority of positions. However, most companies also employ expatriates, those who work outside their country of origin, for a variety of reasons. In some cases, these workers fill skill gaps when local staff is unavailable; in other cases, they may be sent to train local staff or to install companywide systems in areas like IT and finance.

Some may be sent on developmental assignments to gain skills and experience at an early stage of their careers. Increasingly, part of the motivation is to ensure that the company's future top-management cadre has some international experience. Whatever the reason for using expatriates, this relatively small group of people takes a disproportionate amount of HR time. In setting pay for key local staff, employers must ensure that they are competitive with the local job market and that they offer

challenging jobs within a country with the prospect of advancement within that country. However, this approach is insufficient for expatriates, whom employers must view by reference to different countries — where they originated, where they are currently working, where they will next move and where they will ultimately work. In terms of both pay and career, this perspective means taking into account conditions in at least two, but often more, countries.

Expatriates also cost a lot of money — cost-of-living and housing allowances travel home at the company's expense, additional premiums on top of their basic salary and children who must be educated. The overall cost of a typical expatriate assignment can approach \$1 million. In addition, the cost of an international assignment is three times that of a local hire

FACTORS INFLUENCING INTERNATIONAL COMPENSATION

- 0 Growth and interdependence of the world economy
- 0 Stability of the world political system
- 0 Continued growth of economic and political integration at bloc level
- 0 Need for assignees to fill skill gaps
- 0 Degree of compensation and benefits convergence between countries
- 0 Degree of convergence in purchasing power between countries
- 0 Individual willingness or aversion to international relocation
- 0 Cost of relocation in terms of whether it will increase or decrease overall and whether comparative costs by nationality or assignment location will change
- 0 Degree that technical change reduces the need to physically relocate staff
- 0 Changes in corporate structure and culture
- 0 Tolerance of companies

DESIGNING EXPATRIATE COMPENSATION PACKAGES

BASIC QS? ? How to design a competitive expatriate compensation package?  
? Why it is not sufficient to calculate only the Cost of Living Allowance

(COLA)? ? How to define the right compensation level for transfers from low to high cost countries as well as from high to low cost countries? When designing expatriate compensation packages, companies need to take several issues into account. Companies should make their decisions and choose a preferred approach only after carefully weighing key issues such as: Parity among nationalities of expatriates • Equivalent pay with peers in the company • Competitiveness with other multinationals • Repatriation • Ease of administration • Program costs The company's culture, as well as the organizational background of the company also plays a major role in the selection of the desired compensation approach.

TRADITIONAL PAY MODELS ? Balance sheet Features: • Build up from home pay including wide range of benefits • Full income and social security tax equalization • Employee pays hypothetical home-country income and social security tax, remains on Home country payroll Employer pays home and host taxes on grossed up basis • May include personal/investment income & gains and equity income • Common with US-based multinationals Pros: • Consistent application for entire population, regardless of location • Generally seen as generous to the assignee • Eases ease of relocation due to consistency and certainty Cons: • High employer costs due to gross up tax • Significant administration burden for the employer • May hinder repatriation if employee perceives he/she will be “ worse off” ? Net to net Features: • Full or partial tax equalization or protection Home country net compensation calculated. Gross equivalent Host country calculated. Generally paid in host country currency • Home or Host country social security • Generally full range of benefits provided on a net basis • More

common with European-based multinationals

Pros: • Clarity of net pay for employee • Allows some degree of integration with the local workforce • Eases ease of relocation due to consistency and certainty

Cons: • High employer costs due to gross up tax but allows for some savings • Significant administration burden for the employer May hinder repatriation if employee perceives he/she will be “ worse off” ?

Local plus Features: • Assignee has a local Host Country gross salary, equivalent to local workforce performing same role. May be lower than Home country salary.

Assignee pays own local taxes • In addition full or partial range of benefits (e. g. , housing, schooling) provided on a net basis • Often applied for employee-requested moves, wind-down & localization

Pros: • Potentially reduced administration for the employer • Allows greater degree of integration with the local workforce

Cons: • High employer costs due to gross up tax but allows for some savings • May hinder expatriation if employee perceives he/she will be “ worse off” ?

OTHERS ? Tax Protection – Assignee no worse off. Generally involves an end of year retrospective adjustment (NB cash-flow considerations). Common for new entrants in the international arena ?

Country-Specific Policy Application – Policy will differ depending on country combination & is driven by specific tax structures in assignment & home locations ?

Social Security Secondment Assignee remains employed in home country to maintain social security record (& potentially pension) but on local T&Cs /remuneration

WHY ALTERNATIVE PAY MODELS? •The challenge for companies is to maintain equity and consistency among their expatriate population •Expatriates from lower salary level countries suffer from a non-competitive spendable income level when transferred to higher

income countries. • The cost of living allowance does not compensate for significant differences in national compensation structures.

- Even when applying generous indices, expatriates from lower salary countries do not achieve a competitive purchasing power. Encouraging mobility from a low cost country to higher cost country without having to apply the host country compensation approach becomes possible by: (A) Increasing the “ low” country spendable income level to an international and competitive spendable income level (B) Applying the cost of living allowance to the international spend able income
- ALTERNATIVE PAY MODELS ? Lump-Sum Features:
- Assignee total package determined as a lump sum, representing maximum cost to employer. Employee allowed flexibility & choice to elect to receive specific items of compensation within total lump sum cost. Wide or limited range of benefits to select from
  - Total or partial assignee flexibility
- Pros:
- Employee choice and role in package decision making
  - Depending on structure may offer cost savings to employer – cost certainty
  - Potential ease of administration?
- Cons:
- Potential loss of tax savings
  - Depending on structure may represent additional cost to employer ?
- Flexible Pay for Expatriates (FlexPat) Features:
- Akin to domestic compensation for the international context
  - Total package is built up based on balance-sheet methodology
  - Assignee determines how total package will be spent
- Pros:
- Less paternalistic than Balance Sheet line item approach
  - Greater employee independence from employer – package elements reflect personal circumstances, privacy of personal spending retained, increased perception of value of compensation by and to assignee
- Customized compensation – some like to live large & save small, others

like to live modest & save big • Provides opportunity for Program Managers to add value by helping assignees optimize their net compensation, rather than manage a policy with exceptions or no flexibility

Cons: • Potential wide range of permutations Can represent greater cost to employer as tax planning opportunities may be lost • Assignee may not make good or efficient spending decisions • May not work in locations which offer few choices on housing ?

Net-to-Gross Features: • Useful in low-tax jurisdictions like Hong Kong • Derived from net after-tax pay in home country • Calculate upwards from that amount to determine new gross pay in host country

Pros: • Easy to compute and explain • Savings opportunity for the employer • Employee enjoys same net pay • Employer can share the cost benefit with the employee

Cons: May not adequately address the cost of living in host country ?

Destination Pay Features: • Similar to Local Plus • “ Wedge ” used to compensate for the expatriate uplifts • Tax equalization still computed

Pros: • Creates at least a semblance of local parity • Acknowledges the need for extraordinary payments • Can result in reduced employer costs

Cons: • May result in a pay reduction for some • Requires the use of split-pay ?

Global Model Features: • Not home or host-based • Global • Emphasis on longer-term or serial assignments

Pros: • Avoids the stigma of “ local ” or “ localize ” • Anticipates global mobility Diffuses comparability with peers and competition

Cons: • Needs to be designed; subject to compromise and negotiation • Requires a change in mindset by both employer and employee

• Limited applicability

HOME COUNTRY BALANCE SHEET APPROACH Based on the latest Mercer International Assignment Survey, we found that the majority of companies still use the home-country balance sheet approach. This approach provides an assignee with the same standard of living in the

<https://assignbuster.com/compensation-of-expatriates/>

host location as in the home location and follows the “no win, no loss” rule, guaranteeing the assignee home country purchasing power.

With this approach, the calculation of the assignee’s new salary is based on:

- The home-country salary structure
- Adjustments to the cost of living differential, housing, expatriate premiums and tax equalizations

Challenges to the home-country balance sheet approach

This traditional home-country balance sheet approach faces the following challenges:

- Significant differences in salary levels exist between countries. This is coupled with the fact that cost of living allowances does not correct these salary differences. It does not guarantee sufficient purchasing power for employees transferring from a low cost country such as India or the Philippines to a high cost country such as Singapore or Japan. It also raises the following questions:
- Whether the host country compensation approach should be applied in such cases?
- Whether a market rate allowance should be added to compensate for the gap?

The biggest challenge faced by the home-country balance sheet approach is that it was initially designed for transferring employees and families from western-headquartered companies. Consequently, the cost of living indices, housing allowance, and other allowances were designed for transfers from high cost countries to other countries.

However, in today’s global environment, HR professionals need to manage a complex matrix of many different nationalities, different home and host combinations, different salary levels and transfers not just from or to the headquarters but also transfers between subsidiaries. It is important to note that limitations to the home-country balance sheet approach are not due to the cost of living allowance but due to the various salary levels across



countries. This is particularly true in Asia where salary levels vary greatly between countries, for example, comparison of salary levels for similar job positions in Singapore vs. Malaysia, Japan vs. Philippines or Australia vs.

Indonesia show major gaps. Defining the right compensation level The challenge for companies is to maintain equity and consistency among their expatriate population. They do not want to have difficulties in repatriating their assignees, which could be a consequence of applying the host-country compensation approach. Companies using the host approach, integrate employees into the local host salary structure which then makes it very difficult to move these employees to another destination or back home, as a disconnect is created between the salary received in the host location and the home salary.

The graph below shows the wide differences in salary levels across countries for a particular position level. \*International Position Evaluation: Allows for consistent measurement of positions. Expatriates from lower salary level countries suffer from a non-competitive spendable income level when transferred to higher income countries. The cost of living allowance does not compensate for significant differences in national compensation structures. National spendable incomes comparison for management level Even when applying generous indices, expatriates from lower salary countries do not achieve a competitive purchasing power.

Encouraging mobility from a low cost country to higher cost country without having to apply the host country compensation approach becomes possible by: Increasing the “ low” country spendable income level to an international

and competitive spendable income level •Applying the cost of living allowance to the international spendable income This approach still allows companies to apply the home-country balance sheet approach and presents the advantage of being: •Transparent •Easy to calculate •Globally consistent •Cost effective •Repatriation friendly The international spendable income is applied to compensate for the low local spendable income level, thus overcoming the non-competitiveness when sending employees on assignment from a country with a lower salary reference. This approach ensures that the expatriate approach is never below local market rates, nor below the home living standards, and also maintains the home reference salary for pension and insurance schemes, etc. The modified compensation model: The home-country balance sheet compensation approach Choosing the best expatriate compensation approach is difficult. However, when weighing pros and cons of the different approaches, the modified home-balance sheet comes out as the clear winner.

Whilst the host country approach is easy to administer and market driven, it is difficult to apply outside of major locations and is not equitable. The mixed or hybrid approach offers the benefit of never being below local market rates or home living standard, but its pitfalls lie in the difficulty of repatriating or localizing employees. In light of the downfalls of the host and mixed approaches, the modified balance sheet approach remains the most competitive expatriate compensation method, even when moving employees from low cost countries to high cost countries. In conclusion, the modified home-country balance sheet compensation approach is the preferred method of expatriate compensation as it presents the following advantages:

- Worldwide consistency
- A simplified approach using one international assignment policy
- Equalized expatriate allowance costs
- Encourages mobile workforce internationally & regionally
- Diversification with not only HQ Expatriates but also Third Country Nationals and sourcing more talents from subsidiaries
- Allows transfers from low to high country compensation levels with an international adjustment
- Facilitates employee repatriation

ANNEXURE A: CASE STUDY Case study: Expatriate compensation calculation using the international spendable income methodology for a transfer from a lower cost country to a higher cost country An employee based in Mumbai and earning an annual base salary of INR 1, 000, 000 (USD 25, 323) is being transferred to Singapore.

This employee is married with two children. In this modified balance sheet approach, the first step will be to calculate the international spendable income adjustment which is competitive with the purchasing power of the host country and follows the international “ way of life” patterns. Using Mercer’s Global HRMonitor® , we calculate:

1. Net home country pay: Gross home pay - hypothetical tax & social security deduction + family allowances
2. National Spending Income: Net home country pay - housing & savings and other investments
- 3.

International Spendable Income adjustment: International Spendable Income - National Spendable Income (calculated through IS calculator on Global HRMonitor®)