pay liras in Rome

A myriad of aspects have to be considered while deciding international (particularly expatriate) compensation policy. With the number of Indian MNCs on the rise, interest in this are is rapidly growing.

By Shailesh Deshpande

One of the most fascinating aspects of Indian business scenario in the last decade has been the global expansion of Indian companies. In addition to the well known IT examples, a diverse set of companies have entered the international arena with a vengeance: Aditya Birla Group, Ranbaxy, Asian Paints, Essel Propack… the list can just go on. Recent data published by the consultancy India Advisory Partners shows that the year 2004 saw 60 foreign takeovers by Indian companies and the total value of these deals was $1.7 billion.

Needless to say, such a transition to becoming a global player presents a wide range of business challenges. In HR function itself, there would be issues pertaining to labour laws, multicultural workforce and concerns about balancing the need for global consistency with requirement of local responsiveness. But probably the single most complex and significant HR issue would be that of international compensation and benefits.

Coming to terms

1. Expatriate: Employee posted in a country different than her country of origin, typically for a specified duration (3-5 years) of time. Within an organization, only a select group of employees are typically accorded expatriate status. Hence every employee posted in a 'non-origin' country does not become an expatriate by default.
2. Home country / location: Country of origin
3. Host country / assignment country: Country of posting

Pay liras in Rome and rupees in Delhi

It would be so easy to follow this approach! But unfortunately, the truly global corporations with presence in dozens of countries and a maze of regional, global and local positions can't really do this. More often than not, they have a requirement to post a Delhite in Rome and the Italian in Dubai.

So when an Italian gets placed in Delhi, a multitude of factors need to be considered while deciding compensation and benefits, including cost of living, income tax, retirement benefits, insurance, hardships, competitiveness with respect to the local market, internal equity, saving potential, exchange rate fluctuations and so on!

Expected attributes of an expatriate compensation system

Assure employees that they will be 'better off' financially

People getting posted in developed countries may worry about high costs and those getting posted in underdeveloped countries may be concerned about the quality of life, availability of basic goods and services and security. They should get assurance that whichever be the assignment location, their saving potential will go up.

Maintain internal equity

While deciding compensation for these international postings, the internal equity should be maintained. Equity needs to be maintained within expatriates posted at different locations as well as between expatriates and home country employees. Compensation cannot be identical in value, but should ideally be consistent and fair.

Enable easy international transfers

The system should facilitate transfer of people from the host country to international locations and vice versa and also between the locations, without the individual or the organization facing major disturbance.

Ensure that costs are minimized

The system should be not only fair and attractive for employees, but should also minimize the costs for the organization.

Coherently manage various elements of expatriate compensation

It is important to consider impact of various elements like income tax; retirement benefits; salary revision and increment process; variable pay; and fluctuations in exchange rates.

Models of expatriate compensation

A study of the academic literature on international compensation reveals three main models of international compensation:

Home plus approach: The company continues to provide same salary as it was paying in the home country, but may add certain perquisites such as housing etc. at the international location

Host approach: An expatriate is paid as per the prevailing local compensation levels for comparable positions in the country of assignment. No separate adjustments are made to the compensation.

Balance sheet approach: Involves systematically adjusting for cost of living differential between the assignment and home location. The prevailing compensation levels for similar positions in assignment location are not considered to be of any relevance.

Many organizations modify these models (variations such as 'higher of home or host ', 'net to net', or 'host plus' are common) to create their own international compensation systems.

The first two models will not be suitable for an organization that has presence across a very diverse set of countries. For example, a European company having operations in two three countries in Europe, with comparable cost of living and compensation levels can possibly consider the 'host approach'. An Indian company, having operations in Nepal as well as UK can not adopt the host approach, since it will mean great inequality in compensation within the expatriate cadre. The balance sheet model is one of the most elegant and commonly used approaches to expatriate compensation.

The balance sheet model

This model aims at adjusting salary for cost of living differentials across locations. By doing so, it ensures that in the same company, different expatriates of same nationality and of similar profile working in different countries would enjoy similar purchasing power or real wage levels. By design, this model does not factor in what the local market pays for that particular job.

1. Deciding benefits policy for international assignments: Many organizations provide benefits such as furnished house, company maintained car, utility (such as telephone and electricity) expenses, children's education expenses, medical insurance etc. to all international assignees. The calculation for balance sheet compensation needs to factor in this aspect, while determining the cost of living differential.

2. Determining the home spendable: The basic principle of balance sheet model is to adjust of cost of living differentials between home and assignment location. To do this, it is first necessary to establish the basis on which the adjustment needs to be done.

Sample salary of Indian national on expatriate assignment to Brazil

Component	Entitlement (per month)	Entitlement (per annum)
Basic salary	10,000	
HRA or company house	8000	
Car or conveyance allowance	8000	
Special allowance	1000	
Target variable bonus		100,000
Medical reimbursement		15,000
Leave travel allowance		20000
Total		

Note: Appropriate 'spendable table' specifies that a person having the above salary structure in India typically spends Rs. 83412 per annum on the defined goods and services.

Assuming that all the main benefits as described above are provided by the company at assignment location, there is no need to separately adjust for cost differentials pertaining to them. So what are the aspects for which the company needs to make adjustments? These are basically the living expenses i.e. the expenses incurred on food, recreation, clothing, personal care etc.

To decide on the adjustment, it is first necessary to determine the expenses typically incurred by the employees in the home location. This can be done by using 'spendable data tables' for the respective locations, prepared by reliable data providers. Such tables provide typical amount of money spent on the goods and services pertaining to living expenses for various income levels. For example, looking at the standard spendable data table, it can be learnt that a person drawing a gross salary of Rs.5 lacs in India, typically spends Rs.1 lac on a particular defined set of goods and services, for a family of four. It is important to ensure that the appropriate spendable data table is selected, that corresponds with the benefits policy of the company. For example, if the company provides a fully maintained car and fuel to the employee, then the spendable table should not include expenses incurred on that account.

3. Determining cost of living allowance (COLA): Many international compensation firms provide 'cost of living data' for various location combinations. (e.g. India to Sao Paulo, Brazil etc.) By definition, a cost of living index is specific to a particular basket of goods and services. Due to this reason, freely available cost of living indices on the internet etc. are of no use in deciding compensation since they rarely specify the 'reference basket'. Inclusion or otherwise of a single factor such as housing can make a very large difference in the index. While each compensation firm may have its own set of goods and services, the typical basket includes items like food, grocery, dairy, fruits & vegetables; clothing; personal care products; recreation; house care; and eating out. One essential tool to use in this context is the National Expenditure Profile, which is a statistical table for a particular country giving the percentage of home spendable amount typically spent on each goods and services category. To determine the cost differentials experienced by an expatriate these firms conduct pricing surveys in shops typically frequented by these people at home location as well as at assignment location. Within each category, prices of a predetermined set of products are tracked on periodical basis (e.g. within category of house care, price of 2kg pack of Tide detergent is followed). After the pricing surveys are done, the weightages are allocated for various categories as per NEP, prevalent exchange rate is factored in, and the cost of living index is calculated.

4. Deciding policy pertaining to income tax: Expatriate income tax is a complicated issue, and various approaches such as tax protection or tax equalization are possible. Tax equalization approach is the most appropriate option, for use in combination with balance sheet model. This presumes that the expatriate should continue to be liable to same amount of income tax as he would have been in the home location. So the hypothetical income tax that the employee would have incurred at home location is deducted while calculating the international compensation and the actual income tax applicable in the assignment location is paid by the company. This has two merits - firstly, it ensures equity amongst employees based at various locations; and

Illustration of cost of living index calculation

Item: Chicken Burger at McDonalds	Exchange rate 1 Brazilian Real = 18.6 Indian Rupees
Price in India	25 INR
Price in Brazil	3.54 BR = 66 INR
Cost of Living Index= Price in Brazil in INR/ Price in India in INR	= 66/25 = 2.64*

Assumption: Basket consists of only one item.

**COLA = (COLI -1) * Home spendable. Assuming actual COLI for India to Sau Paolo to be 2.64, the COLA applicable in above case will be: (2.64 - 1) * 83412 = 136796 INR PA*

The cost of living allowance represents the additional amount that needs to be paid to the expatriate to neutralize the difference between the cost of living expenses in the home and assignment locations.

secondly, an employee does not get impacted by differences in taxation across locations when he his transferred.

For example, if the gross salary of two individuals is 100, and the tax rate at home location is 30%, and they are posted at two locations with tax rate of 10 % and 40 % respectively. While calculating the international compensation applicable to them, hypothetical tax deduction equal to 30 will be made and the actual tax applicable at the assignment locations will be directly paid by the company.

5. Deciding policy pertaining to special allowances: Two most commonly considered special allowances are the assignment allowance and the hardship allowance. The assignment allowance is provided as a financial incentive for employees to take up international posting, and is paid to all employees who take up such posting. The company needs to frame a policy for calculating this. It is commonly defined as a certain % of the base salary with certain minimum and maximum limits defined. The hardship allowance - This is an added financial incentive paid only to employees who take up assignments at locations that are defined as hardship locations. Companies need to define the parameters based on which a particular location may get classified as hardship location. The assumption in the example above is that the Assignment Allowance is equal to five month's basic salary, i.e. 50,000 INR and hardship allowance is two month's basic salary, i.e. 20,000 INR.

6. Calculating total salary applicable at assignment location

All figures in INR per annum		
Total cash at India	152000	(Allowances pertaining to benefits provided at assignment such as housing to be excluded) [From step 1=Basic-10000*12+ Spl Allow 1000*12 + LTA 20000]
+ COLA	+136796	[From step 3]
+ International assignment allowance	+50000	[From step 5]
+ Hardship allowance	+20000	[From step 5]
- Less income tax at India	-18440	As per prevailing Indian Income tax law
= Total net of tax salary at the assignment location	= 340356	

7. Deciding policy with reference to currency administration: One can either pay the entire salary in assignment location currency; or pay the entire salary in a global currency such as US dollars or euro; or split the salary based on significance of the components and define them in separate currencies. Obviously, the first two options expose the employees as well as the organization to vagaries of exchange rate fluctuation and are not sound in principle, though administratively most convenient. The third option, while complex, is the most appropriate approach to follow, considering the stated principles of balance sheet compensation. This involves splitting the total compensation in two parts, one being assignment location component and the other being home location component. Assignment location component represents the portion of the compensation the employee would typically spend at the assignment location on living expenses and is specified in assignment location currency. The balance portion of the compensation represents the part available for the employee for discretionary spending or reserves, which is specified in home currency. This ensures that the 'reserves' part of the employee's compensation is protected from any exchange rate fluctuations and remains constant in the home currency value. The home component can either be paid in the home location, or paid in assignment location in either local currency or global currency to ensure that the defined value is delivered to the employee in home currency as per prevailing exchange rates.

Assignment location component = Home spendable + COLA

Home location component = Total salary (Step 6) - Assignment location component

For example: Assignment Location component = 83412 (from step 1) + 136796 (from step 3) = 220208 INR = 18351 INR per month = 987 Brazilian Real PM (using the exchange rate used in calculation of COLI)

Home location component = Total salary (from step 6) - assignment location component = 120148 INR = 10012 INR PM

Since hypothetical income tax as applicable in India has already been deducted, the figures indicated above represent the 'net of tax' salary. Actual income tax applicable at Brazil has to be paid over and above this, by the company.

Other elements of compensation policy

Since the starting point in the balance sheet model is the home country compensation system and the guiding principle is equity, an expatriate is awarded increments as if he was in the home country and the expatriate compensation is recalculated as per the new home country salary. Expatriates should typically continue to be anchored to the variable pay plans that were applicable to them in the home country. This means that the 'target variable bonus' continues to be same as it was in the home location. Further, wherever possible, the expatriates continue to participate in the home country retirement plans (PF, pension etc.), some companies also offer global retirement plans. The local legal framework in the assignment location needs to be considered while deciding on this.

Issue of equity with local employees

As it can be seen, balance sheet model implies creation of a special expatriate cadre, having different benefits, salary structure, increments and variable pay, than what is applicable for local employees. In many cases, it may so happen that an expatriate functional head ends up drawing more compensation than his superior, the local business head of the company. This is a very sensitive issue and needs to be handled with great care. Each company needs to do a cost to benefit analysis of this system before taking the decision. The commonest approach adopted by organizations is to state transparently the policies applicable to expatriate cadre and to clearly articulate the principle that the local compensation and the expatriate compensation are to be seen as two different systems, not to be compared with one another. The only response to a local employee who feels aggrieved by the inequality vis-a-vis expatriates is an assurance that if he were to take up an international posting, the same approach will be followed towards the compensation applicable to him. On the other hand, a situation may also arise that the expatriate ends up getting much lesser compensation than his local counterparts and prevalent levels for similar jobs, but such comparison is not considered relevant under this system.

As it can be seen, an approach such as balance sheet expatriate compensation would require an organization to establish a system for exchange rate adjustments, conduct revisions based on changes in cost of living, income tax laws, etc. In order to avoid these administrative difficulties, certain organizations may adopt alternative options such as directly fixing a lumpsum compensation for various levels in different locations. While such systems may be easy to administer, they can neither systematically assure equity in compensation nor conclusively establish that the difference in cost of living is being adjusted in a consistent manner.

Most of the Indian companies that have recently expanded their global operations are in process of evolving their international HR policies and the need of the hour is to 'get it right the first time '. This is especially critical because systems like compensation are extremely sensitive and it is not possible to make frequent modifications. Needless to say, each organization should endeavor to evolve systems most suitable for their own unique context and to most appropriately serve their business agenda. While doing so, it may be very useful to study processes like balance sheet expatriate compensation that have been commonly practiced by global companies, and use the learnings in design of HR processes. HC

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