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WORKING PAPER SERIES

Rethinking International Compensation: From Expatriate and National Cultures to Strategic Flexibility

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Rethinking International Compensation:

The logic of the global marketplace argues for strategic flexibility, rather than national culture, as the basis for pay

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Rethinking International Compensation

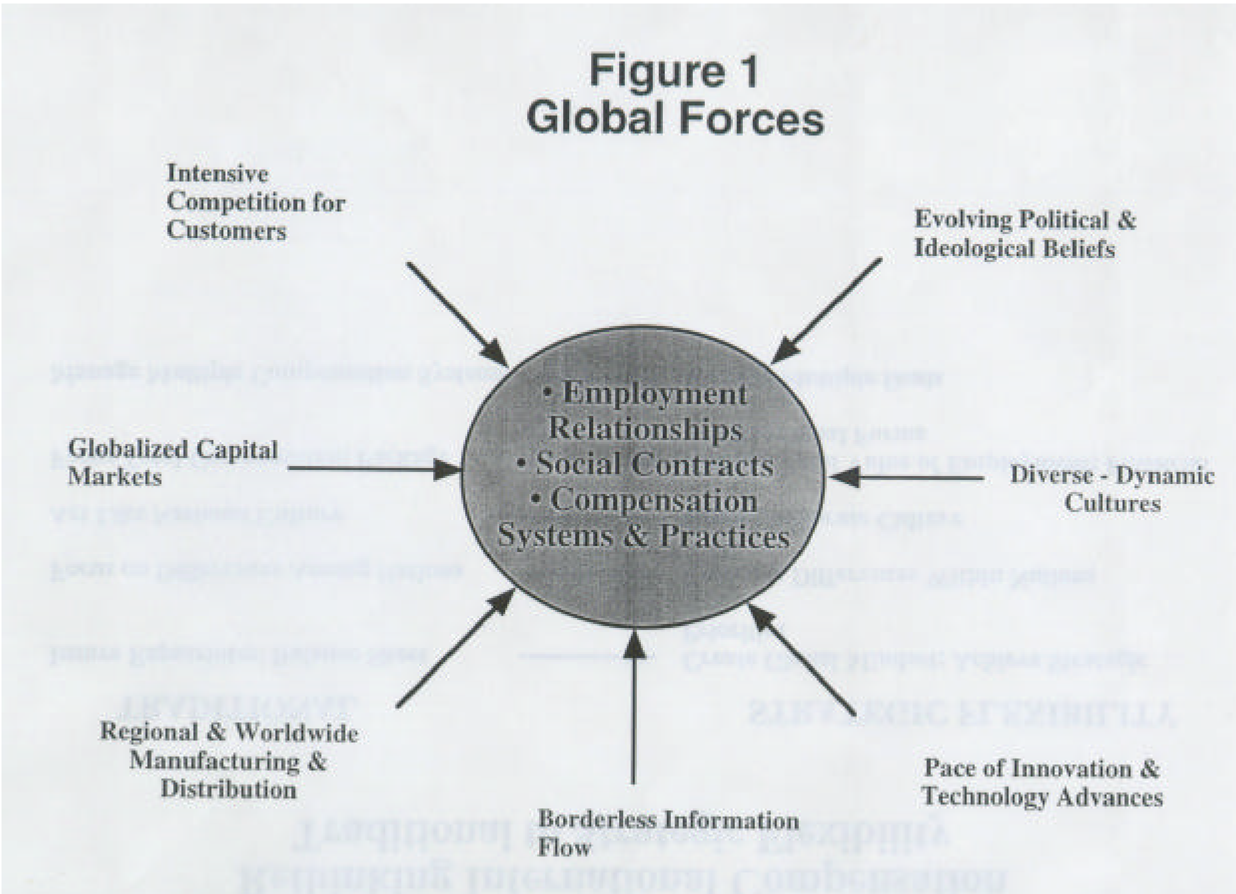
We are on the verge of a worldwide restructuring of compensation and reward systems. Even long established, seemingly carved-in-granite cultural norms, such as lifetime employment in Japan and industry-wide bargaining in Germany, are weakening in response to the pressures of a global economy. So also are our previously hard-and-fast assumptions about international compensation -- the idea that pay systems should keep expatriates “economically whole” and the notion that local compensation should be tailored to fit national cultures.

True, from a global perspective, there are still substantial differences in the ways people get paid. Consider, for example, that the pay packages offered by the same multinational operating in both Shanghai and Bratislava are very different. In Shanghai, the package may emphasize housing allowances and bonuses intended to retain scarce critical skills, while in Bratislava the package will place greater emphasis on productivity-based gainsharing and base pay.

Yet the logic of market-based economies suggests that these differences will narrow as players worldwide cope with similar pressures. All are affected by intense competition for customers and critical skills; all or are influenced by global financial markets; and all seek to understand and leverage the enormous (and increasingly less restricted) flow of information and technology across national boundaries. All are strive to harmonize their regional and global manufacturing and distribution systems. Exhibit 1 depicts some of the global forces at work.

While all companies playing in the international market face similar pressures, responses differ. In Europe, the French are changing their compensation systems only gradually. French voters continue to place a high value on their country's wide-ranging social safety net. Consequently, French managers are using share-the-work schemes to cope with the country's high unemployment. Other Europeans, notably the British, permit the parties to adopt more variable systems, including stock options and performance-based schemes. So, even though the pressures created under market-based economies are similar, the players who determine how people get paid have considerable freedom when choosing how to respond.

Different responses to globalization highlight the fact that compensation and reward systems are part of the overall relationships between people and employers around the world. These relationships are entwined within social, political, and economic contexts. We are witnessing different approaches to balancing these pressures within those relationships. The changes occurring bring to mind the old children's game of rock-scissors-paper: rock crushes scissors, scissors cuts paper, and paper covers rock. Rock, scissors, and paper interact with each other in the same way the pressures depicted in Exhibit 1 interact and, in turn, cause compensation and reward systems to adapt.



Creating Global Mind-sets

The pressures generated by globalization and market-based economies create unprecedented opportunities for multinational employers. Increasingly, company leaders are recognizing that global mind-sets are required to meet these challenges, and create opportunities.

A global mind-set means adopting values or attitudes to create a common mental programming for balancing corporate, business unit, and functional priorities on a worldwide scale. Such a mind-set has enormous intellectual and thus competitive advantages. According to Jack Welch, CEO at General Electric, "The aim in a global business is to get the best ideas from everyone, everywhere.... I think [employees] see that if you are going to grow in GE, you are not going to have a domestic background all your life."

This perspective goes beyond "think globally, act locally." It seems to imply the converse: "Think locally but act globally."

Compensation and reward systems can become crucial tools to support this global mind-set--or they can form major obstacles blocking the way. For organizations competing in worldwide markets, managing compensation and reward systems has always depended on understanding the economic, social, and political changes occurring in the countries in which they operate. What is emerging is that some companies are adopting global compensation and reward strategies that are aligned with and signal their global mind-sets. Rather than only reacting to and matching local conditions, the global perspective shifts to finding how they can best use compensation and rewards to compete on a worldwide basis.

Expatriate and National Systems Thinking

Ask compensation directors to describe how international compensation and rewards are managed in their firms, and they typically offer one of two responses. Some describe their recent efforts to modify the balance sheet approach for paying expatriates. Most of these efforts attempt to better align compensation costs with the purposes of different global assignments by distinguishing between developmental and longer-term technology transfers and leadership roles.

Other compensation directors think in terms of different national cultures. They point out the importance of localizing compensation decisions within broad corporate principles. Their purpose is to better align compensation decisions with differences in national cultures. Usually the broad corporate principles seem to be relevant only at 10,000 meters, as in "support the corporate values and global business strategy."

The reality is that local conditions dominate the compensation strategy. Justifications of this practice inevitably include statements like, "You must understand that the United States has a highly individualistic national culture. In other places in the world, particularly Asia, people are comfortable with more collective values. Security is more important than risk taking. You need to be sensitive to 'saving face,'" and so on. These executives seem to believe that something called "national culture" is a critical (perhaps the most critical) factor when managing international compensation.

Now ask those same executives the question posed above, but delete the word *international,* i.e., and “Describe how your organization manages compensation." Executives now talk about initiatives to create a common culture of ownership and performance. They say they want to build flexible, agile cultures through practices such as broad banding, broad-based stock option eligibility, 360-degree assessment, and competency-based projects.

So, on the domestic front, they place emphasis on strategic choice and on crafting compensation strategies to help create an organization culture sensitive to markets and performance. Yet internationally, concern with aligning compensation with different national cultures dominates. Most managers subscribe to this approach as consistent with the belief that competitive advantage is achieved via transforming multinationals into local companies.

This view conforms to the often-heard conventional wisdom that the best, indeed, the *only* way to manage international compensation is to tailor it to local conditions and the national culture--to think globally but act locally. Too often the reality is a matter of *reacting,* not acting, locally.

Traditionally, "International" Means "National"

Generally, the traditional perspective is based on the premise that different national systems of compensation and reward are strategic. Discussions, for example, focus on contrasting the German, Japanese, and U.S. approaches. To a large measure, this view reflects the critical importance of government, laws, and regulations, especially tax policies, in determining pay practices. Consequently, understanding these regulations and perhaps undertaking initiatives to change them remain important responsibilities in international compensation.

But this national-system approach goes beyond focusing on regulatory differences among nations; it rests largely on three tenuous assumptions:

1. that national borders largely define the important attributes of people and must be considered when designing compensation and reward systems,
2. that differences between nations are greater and more relevant to managing international compensation than differences within nations, and
3. that something called "national culture" exists and is a significant factor in global approaches to compensation and reward.

Nations and Regions versus Strategies and Markets

Does it still make sense to view international compensation in terms of national systems when there appears to be considerable variation in compensation and rewards *within* nations as well as between them?

Recent studies in China, for example, report substantial differences in pay and reward systems associated with differences in the governance and ownership. In general, pay packages provided in state-owned enterprises emphasize services, benefit allowances (housing, food, healthcare, childcare, etc.), and relatively lower cash. Joint ventures and wholly foreign owned subsidiaries use widely divergent approaches, some emphasizing highly risky variable pay, others emphasizing careers, training opportunities, and moderate cash.

Studies of Japanese companies' HR strategies report differences in compensation approaches associated with organization profitability size degree of unionization, capital-labor ratio, and exposure to global competitive forces. For example, Japanese companies operating in protected domestic markets are more likely to use the more performance- and ability-based schemes. Among Korean chaebols, factors such as labor market conditions, customer and supplier relations, economic conditions, and technology account for differences in compensation strategies.

Studies of person-based rewards in samples from Hungarian and U.S. companies suggest that political, economic, and institutional forces, rather than national cultures, explain differences in Hungarian and U.S. reward practices. Recent surveys in the Central European countries of Slovenia and Slovakia also report differences among companies in their use of variable performance-based pay schemes, allowances and services, and even in the ratios of top managing directors' salaries to the average worker.

While the recent evidence does not suggest that national boundaries (national wage systems) should be ignored or overlooked, it does suggest that sufficient discretion for individual organizations exists within these national systems to allow organizations to customize compensation and reward systems. Hence, business strategy and markets are more appropriate than countries as the unit of analysis for globalizing compensation.

The Strategic (In) Significance of National Cultures

Are compensation and reward systems in a global context better understood by examining differences in *national* cultures--or by examining more *local* cultures, particularly those within organizations?

The assumption that compensation systems must fit national cultures is based on the belief that "most of a country's inhabitants share a national character...that...represents mental programming for processing ideas and information that these people have in common." This belief leads to a search for distinct national characteristics whose influence is then assumed to be critical in managing international compensation systems.

Typical of this mode of thinking is the widely used cultural attributes proposed by Geert Hofstede (power distance, individualism-collectivism, uncertainty avoidance, and masculinity/femininity) or by Trompenaars (individualism versus collectivism, achievement versus ascription, universalism versus particularism, neutral versus affective, specific versus diffuse).

Following this view, some argue that compensation systems in countries where the culture emphasizes respect for status and hierarchy and thus produces higher power distance scores (Malaysia and Mexico) should exhibit more hierarchical pay structures, while those manifesting low power distance (Australia and the Netherlands) would choose more egalitarian systems. In nations identified as individualistic (U.S., U.K., Canada), compensation and rewards would support employability and individual and performance-based pay. Those in more collectivist nations (Singapore, Japan) would choose more group-based approaches, and so on.

This national culture approach prescribes that compensation and reward policies must be aligned with and reinforce attributes of national culture. Proponents of this approach might argue, for example, that "Giving the kind of direct performance feedback required under most merit and bonus plans fails to account for saving face, which is so crucial in Asian cultures." Or they might say, "In Germany, MBO was favorably received, because Germans prefer decentralization and formal rules."

One might well react to such thinking by pointing out that it engenders blatant stereotyping. It parallels such biased notions as "all women desire time off because of their caring and nurturing values, while all men desire more time at work to pursue their more aggressive values."

It has long been recognized that compensation and reward systems, because of their social as well as economic significance, exemplify and reinforce cultural norms. However, this does not mean that social and cultural norms necessarily coincide with national boundaries. Indeed, 100 years ago, writers recognized that mining and textile companies developed their own unique social norms--and that the compensation systems of these companies reflected those norms.

The idea of a "national culture" requires a leap of logic in assuming that social norms and cultural values are solely national in character. Clearly, geopolitical boundaries alone do not determine cultural values and social norms. Nations comprise a variety of subgroups and subcultures, and anecdotal and empirical evidence suggests that local cultural values as well as values within organizations differ significantly.

Consider, for example, that the former Czechoslovakia included Czechs and Slovaks; now each of these two republics includes groups that exhibit Hungarian and Roman cultural characteristics. Historically, China has always been a composite of several groups; even today, Chinese make culturally laden distinctions between Shanghai, Beijing, and Hong Kong.

Listening to U.S. politicians during election time, one quickly realizes that the United States is made up of many different subcultures that do not conform to geographic boundaries. As pluralism and other influences of globalization increase around the world, some cultural researchers believe that the cultures of small subgroups will become much more important for shaping human behavior than norms at larger societal or national levels. Even when viewed at the national level, revisions may already have occurred. Recent studies suggest that work-related values are changing in China and the U.S. and that these changes are related to differences in reward allocation preferences.

Indeed, it seems increasingly inappropriate to begin analysis for compensation systems at the national level. We recently completed a study of values placed on individualism-collectivism and risk taking at four companies, two in the U.S. and two in Slovenia. The averages of these intra-country distributions were slightly different: Slovenian employees tended to be more individualistic and more inclined to take risks than U.S. employees. Yet Hofstede's work suggests that Yugoslavs, of which Slovenia is a former republic, should be risk averse and collectivistic. The striking feature, however, was that the variances of the distributions were virtually the same. Thus, one can find risk averse collectivists and risk-taking individualists in the U.S., Slovenia, and most likely in many other nations as well.

Our research suggests that paying attention to average levels across national cultures may be misleading. It fails to account for the significant variation within countries that creates sufficient overlap with the distributions in other countries. Closer analysis reveals that political, economic, institutional, and other forces (rather than national culture) explain a significant amount of variation in the expressed desires of employees from different countries. For example, U.S. workers may desire two weeks of vacation, not because of culture, but because that is the norm in the U.S. In Germany, the norm is one month or more. Transfer a U.S. worker to Germany, and the employee will likely want the month; two weeks will no longer be sufficient.

Does It Pay to Be Different?

Are compensation and reward systems in a global context better understood by examining competitive strategies of specific enterprises, or by focusing on differences in national culture and institutions (e.g., public policy)?

Obviously, national public policy, which reflects social contracts among unions, employers, financial institutions and people, is an important influence on compensation and reward systems. For example, differences in the use of stock options in Germany and Japan compared with the United States and United Kingdom are directly related to national tax and regulation policies. Differences in marginal tax rates are directly associated with the use of variable pay schemes. In Korea or Japan, for example, employees prefer increases in bonuses and allowances (not based on performance) rather than base pay increments. Social security and national health insurance rates paid by employers are calculated on base pay, not bonuses or allowances. In the U.S., many benefit forms are not subject to income tax and are therefore a relatively tax effective way to increase the value of employment for people.

The degree of discretion available to managers when they respond to governmental initiatives is often not a simple matter of compliance. Except in rare cases, firms usually have alternatives in terms of the strength and pervasiveness of their response to governmental actions. For example, structuring compensation practices around U.S. tax laws has led to some very creative and innovative new compensation schemes (e.g., deferred compensation plans, ESOPs, phantom stock options). These are used by some firms, but certainly not all. Thus, even the "how" of complying with public policies is a strategic choice.

In the same way, firms operating within so-called national cultures exhibit a variety of responses. Each organization's human resource policies and practices create a distinctive and unique culture that influences people's attitudes and work behaviors. Those people who do not fit the organization culture because they possess different values will either not join or will soon leave the organization.

Signaling Organization Cultures, Not National Cultures

Compensation and reward systems can become an important signal of an organization' culture and values. As such, the systems help create cultures or mind-sets that are different and distinct from the cultures and values of competing firms. Hewlett-Packard and Microsoft both compete vigorously for software engineers, yet each company exhibits a different corporate culture, signaled by and reinforced in their respective compensation systems. The same logic applies to Toyota and Toshiba--different cultures and different compensation and reward systems.

Given sufficient variation in values among the people in the labor pools of a nation, firms can structure compensation policies that are consistent with the firm's culture and simultaneously attract individuals from the applicant pool who have similar values. When considered from a strategic perspective, organizations could customize compensation systems to help create a culture and attract a workforce that possesses the values, knowledge, skills, and abilities that support the organization's strategic goals and objectives.

Strategic Flexibility: Managing Multiple Deals

Strategic flexibility in global compensation and reward systems starts with understanding how the company plans to win. What is its strategic intent? What is its global mind-set?

As depicted in Exhibit 2, strategic flexibility is based on the premise that understanding and managing total compensation in a global business shifts thinking away from using a balance sheet to keep expatriates economically whole or relying on stereotypical notions of differences among nations. The focus, rather, is on understanding and leveraging differences within and between nations.

To be sure, national laws, particularly tax and welfare regulations, are important forces. Yet logic argues that understanding differences and variability within as well as between nations reinforces strategic concerns. In the U.S., no manager presumes all the people are equal to the U.S. average; differences matter. It's the same around the world. In addition, the focus on differences helps managers think in terms of shaping a common mind-set and creating and energizing a workforce with shared values and the capabilities necessary to achieve success.

Figure 2: Rethinking International Compensation
Traditional to Strategic Flexibility

TRADITIONAL		STRATEGIC FLEXIBILITY
Insures Expatriates' Balance Sheet	→	Create Global Mindset; Achieve Strategic Priorities
Focus on Differences Among Nations	→	Leverages Differences Within Nations
Act Like National Culture	→	Grow Corporate Culture
Focus Total Compensation Package	→	Manage Total Value of Employment; Financial and Relational Forms
Manage Multiple Compensation Systems	→	Manage Multiple Deals

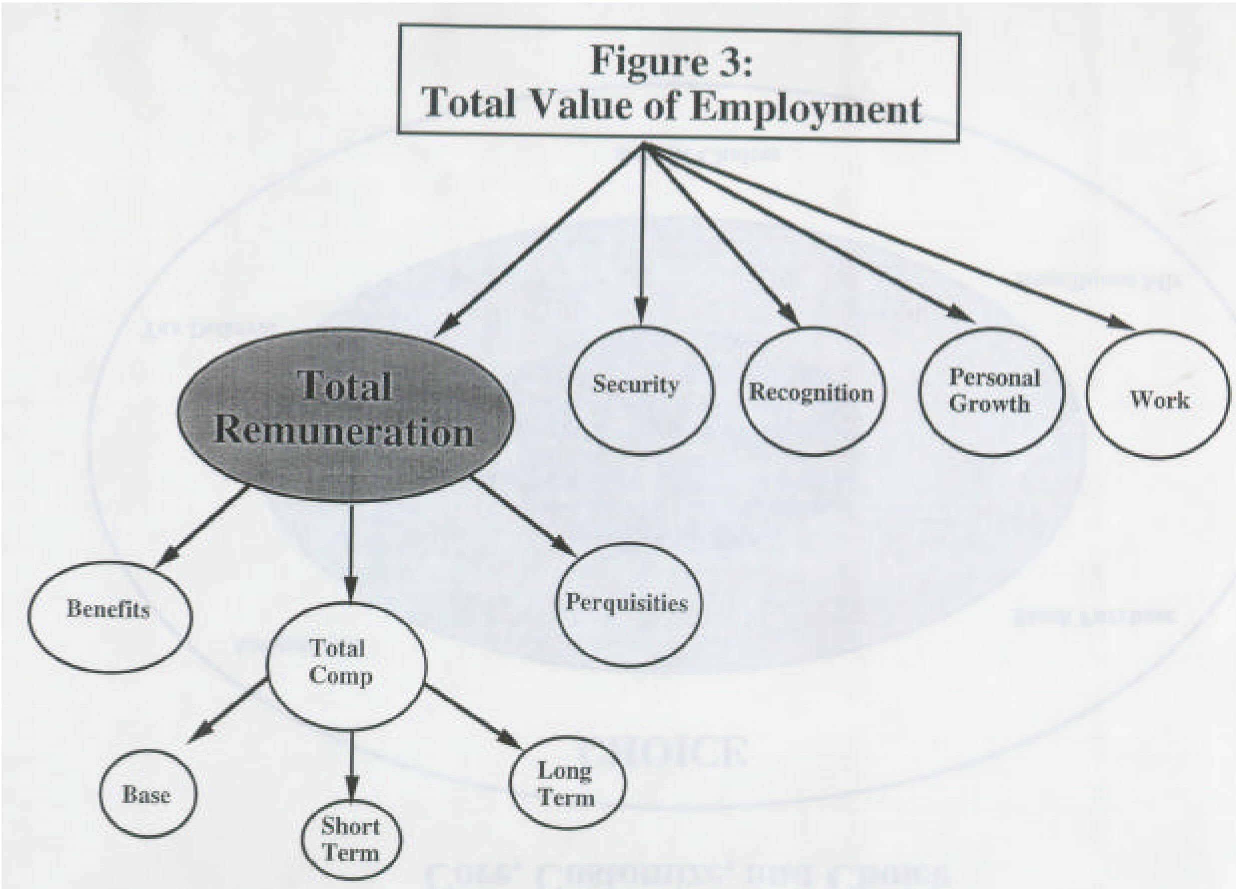
If the global business strategy involves paying less attention to boundaries, sharing ideas and intelligence, harmonizing manufacturing and the distribution process to take advantage of economies of scale, and presenting one face to the customer, then a global compensation system should be crafted to signal this--and reward behaviors to achieve it.

At the same time, we need to recognize that creative tension occurs when a global business strives to achieve a common mind-set and common strategic objectives while simultaneously operating in numerous, complex, rapidly changing markets and locations.

Strategic flexibility means that companies achieve advantage by customizing multiple compensation and reward systems. This is already the state of practice in companies operating in multiple markets or employing contingent and core workforces. The art is to avoid the chaos created when multiple systems go off in multiple directions. This results in numerous compensation systems, one for each country in which the company operates. To overcome the chaos, the company must ensure that the multiple deals signal the organization's global mind-set and support its strategic priorities.

The strategic flexibility model presumes that all these complexities cannot be predetermined and indeed are constantly changing. So an adaptive, more flexible approach is required--one that creates a total value of employment consistent with local conditions, while at the same time forging the common mind-set required by business priorities. It supports business priorities not through a set of chameleon-like systems tailored to varying conditions, but from systems that focus attention on what matters to business success and influences employees' actions consistent with an organization's priorities.

Creating and managing multiple deals to support a global business is consistent with the current practice of broadening the definition of total compensation to include the total value of employment. As shown in Exhibit 3, total compensation includes cash, benefits, and long-term incentives as well as employment security conditions, flexible work schedules, learning opportunities, and so on. There is a growing realization that focusing only on the financial forms of total compensation creates transactional relationships that can be easily copied or purchased by competitors. Financial returns alone cannot extract the unique, value-adding ideas and behaviors possessed by employees. Financial returns alone are ineffective in creating the common mind-set that creates peoples' willingness to share the insights and tacit knowledge required to achieve and sustain advantage.



Relational Returns

Broader thinking that includes both financial and relational returns is required. Relational returns may bind individuals more strongly to the organization because they can answer those special individual needs that cannot be met as effectively with economic returns (e.g., providing for childcare via the noneconomic return of flexible work schedules, versus the financial return of salary to pay for childcare. The flexible schedule puts a parent, not a caregiver, at home). The total value of employment, comprising both relational and financial returns, creates broad, flexible exchanges or deals with employees. Multiple deals encompass a broad range of exchanges and can help create commitment to common values, goals, and the pursuit of mutually beneficial long-term objectives.

Thus, an adaptive, more flexible approach is required. It must permit multiple employment relationships that allow organizations to recognize local conditions when necessary, while at the same time creating the common mind-set among employees required to direct their efforts toward strategic priorities. This approach recognizes that variations in beliefs, opinions, and values within countries provide opportunities for organizations to attract people who thrive in the organization's unique culture, rather than trying to make the organization conform to national cultures.

Flexibility, choice, and managing risk form the essence of this thinking. It begins by viewing the employment relationship as an exchange. Under this view, both the employer and employee make contributions and extract returns from the relationship. A critical principle is that the returns offered by the employer are the primary determinants of the contributions provided by employees. That is, what employees are willing to give to the organization is determined in large part by what the employer is willing to give to the employee. There is no chicken-and-egg search here; the employer's choices come first and determine the employees' response. However, once this relationship is underway, it becomes dynamic and recursive.

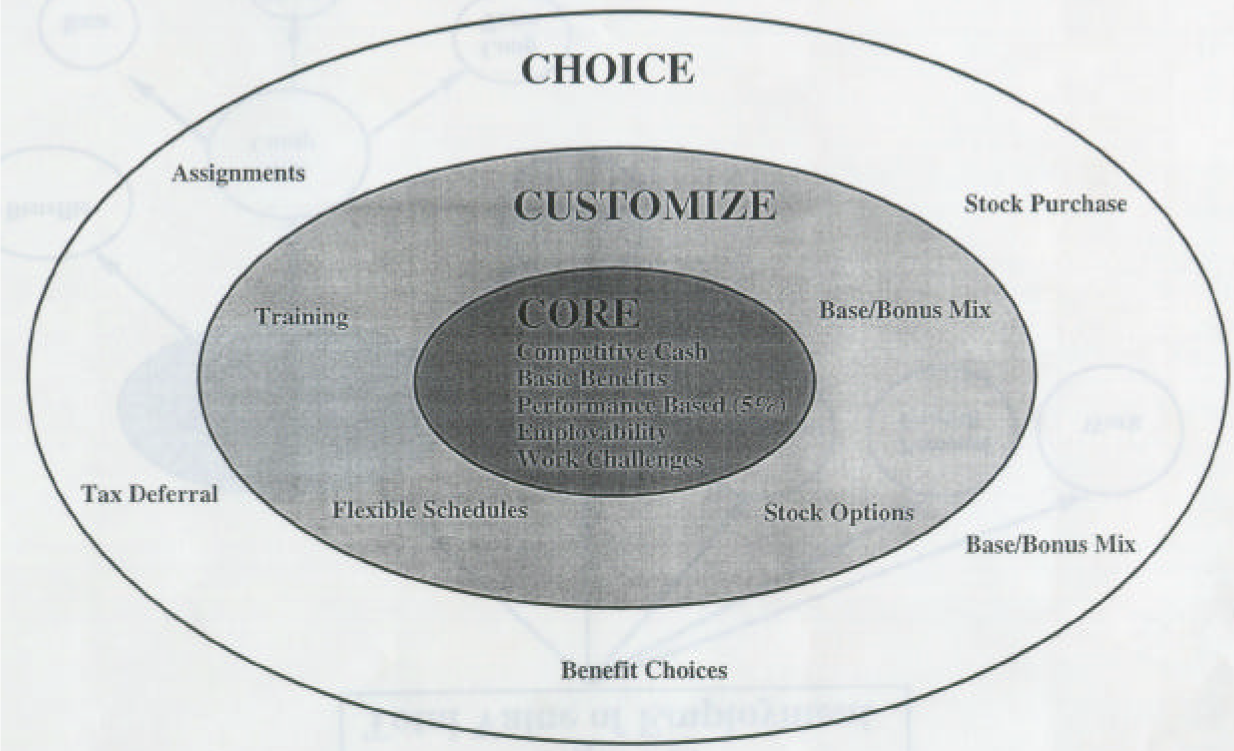
Total Compensation

The objective, then, is to structure the total value of employment so that employee contributions support organizational goals.

The model in Exhibit 4 groups different forms of total compensation into three sets: core, crafted, and choice. It includes any return an organization can offer that employees see as a reward or a return for the contributions they make on the organization's behalf.

The *core* section of the model includes compensation and reward forms that signal the corporate global mind-set (e.g., creating a performance/customer service culture or a culture of ownership, insuring a basic level of services and benefits). Specific practices may vary according to market and local conditions but must be consistent with the core policies.

Figure 4
Strategic Flexibility:
Core, Customize, and Choice



The *crafted* set of compensation elements in Exhibit 4 assumes that business unit or regional leaders have discretion to choose among a menu of total compensation forms that may be important to gain and sustain advantage in the markets in which they operate. For example, some form of housing assistance (loans, allowances, dormitories) may make sense in Shanghai, whereas in London or Tokyo, transportation assistance may make more sense. A single company with operating units in San Jose and Kuala Lumpur may find that specific elements (e.g., risk sharing, bonuses, language training, and flexible schedules) may be more important in California than in Kuala Lumpur.

The critical focus of the crafted alternatives is to offer operating units the ability to further customize their total compensation package to achieve their business objectives. This crafted portion is created within the framework of core returns so that it supports and reinforces corporate priorities and culture as well. Thus, managers of R&D units can craft returns to support their goals and satisfy the preferences of scientists, while the sales unit can craft a different set of returns consistent with sales goals and preferences of sales personnel.

Finally, the alternatives in the *choice* set offer flexibility for employees to select among various forms of total compensation. Analogous to flexible benefits, the choice set shifts the focus of customizing compensation from managers to employees. Examples here might include opportunities to take educational leaves to become eligible for regional or global assignments, 401k-like wealth creating arrangements, or differing employment security arrangements (e.g., contract terms for managers and professionals).

The choice set recognizes the difficulties in identifying national cultures by taking the notion of customizing to the individual level. Within a total cost framework, employees would be given the opportunity to select from a set of returns those that are of most value to their particular situation.

So the strategic flexibility model offers managers the opportunity to tailor the total compensation system to fit the context in which they compete within a framework of corporate principles. Additionally, the approach offers some opportunity for employees to select forms of returns that meet their individual needs as well.

Many companies are already using some of this strategic flexibility model. In global organizations, the business units or regions often have discretion to customize their compensation system within corporate guidelines. For some companies, the strategic flexibility model simply draws existing practices under one umbrella. For example, it treats expatriates as simply another group, much like sales disciplines.

At the same time, however, other companies operate with their international compensation and reward systems pointed in many different directions. Global mind-sets may not be obvious and the global strategic priorities may not be supported. For these firms, directing compensation and reward systems strategically provides an opportunity to gain a competitive advantage.