

DESIGNING COMPETITIVE INTERNATIONAL COMPENSATION PROGRAMS

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RESUMO: Nos últimos 25 anos, administradores expatriados têm manifestado insatisfação com sua remuneração. Este artigo adota uma abordagem prescritiva ao indicar os vários componentes de uma estratégia internacional de recursos humanos bem-sucedida e ao ressaltar os ingredientes cruciais de planos de remuneração internacionais eficazes. O artigo dá ênfase à observância de valores culturais e justiça distributiva próprios de outras nações e culturas.

ABSTRACT: Over the past 25 years, expatriate managers have voiced increased disenchantment with their compensation packages while abroad. This paper takes a prescriptive approach, outlining several elements of a successful human resources strategy and stressing key ingredients of effective international compensation programs. Particular attention is given to the adherence of cultural values and distributive justice when working across nations and cultures.

PALAVRAS-CHAVE: remuneração, remuneração internacional, pagamento, incentivos, planos de pagamento.

KEY WORDS: compensation, international compensation, pay, reward systems, incentives, international reward policies.

The Multinational Corporation (MNC) is one of the most important economic, social, and practical developments of the twentieth century. In contrast to conducting business in one country, global business operations require a higher order of management skills to organize and coordinate complex operational and decision-making systems.

The problems of international compensation are one aspect of this complexity and coordination. They must adapt to differing local laws, cultural values, and social traditions, not to mention differing runaway rates of inflation, politics, and apparent inequities in salary levels among expatriates and local nationals. Such issues appear to be universal concerns of MNCs.

Not surprisingly, the design and management of compensation programs for multiple work forces around the world presents numerous challenges. These activities absorb the bulk of the time and energy of the typical international human resources manager. According to Peter Drucker, successful working compensation policies for managers in multinational businesses are hard to find. American companies share the same frustration and confusion as European or Japanese ones. Compensation policies in MNCs are forever being restudied, reorganized, and revised.¹

In 1966, a survey was conducted among 2301 executives in 40 countries which received 1161 responses. Of those who responded, 893 were executives born in the United States, 243 were executives born elsewhere, and 25 were American citizens born to citizens of the United States working in foreign countries. At that time, an estimated 30,000 executives from the United States were working overseas. The advantage of undertaking a foreign assignment most frequently mentioned by these executives was higher pay.

In the same survey, the respondents were asked to reply to the following open-ended question: "What circumstances influenced your decision to accept the overseas assignment?" Financial reward, including tax advantage, was named by 13 percent of the respondents, whereas another 37 percent (the highest percentage) responded that the principal factor in their decision to go

overseas lay in the opportunity for advancement and recognition.²

If one accepts that in societies like the United States, career advancement and recognition are measured by financial reward, we may conclude that the financial package

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accompanying an appointment is of utmost importance for most executives. However, a quarter of a century later, expatriates do not seem to be satisfied with their remuneration.³ Approximately 77 percent of the expatriates under study expressed dissatisfaction with their salary, benefits and international compensation package in general. A significant portion of this dissatisfaction was related to feelings of inequity in their salaries and benefits.⁴

In another survey, expatriate managers declared they were satisfied with their financial packages but dissatisfied with the limited career planning, life-style support, and cultural training provided.⁵ The above examples illustrate the extent to which the design of an international compensation program must be related to the development of the company's international human resource strategy. This article describes the major elements to consider in such a strategy and the design of an international compensation program. It also examines some dilemmas of international compensation programs and offers recommendations for addressing them.

1. DRUCKER, Peter F. *Management: tasks, responsibilities, practices*. New York: Harper & Row, p.751, 1974.

2. GONZALEZ, Richard F. and ANANT R. Negandi. *The United States Overseas Executive: his orientation and career patterns*. Institute for International Business and Economic Development Studies, Divisions of Research, Graduate School of Business Administration, Michigan State University, 1967.

3. BLACK, J.S. Returning expatriates feel foreign in their native land. *Personnel*, Aug. 1991, p. 17

4. Idem, *ibidem*.

5. SHRM/CCH Survey on International HR Practices. Chicago: Commerce Clearing House, 1992.

ELEMENTS OF AN INTERNATIONAL HUMAN RESOURCE STRATEGY

Personnel strategy and mix

The development of a personnel strategy must start with an understanding of the needs of overseas markets and their personnel requirements. Among many other factors, a company's international human resource strategy must consider the use of three groups of personnel: expatriates, local nationals, and third-country nationals:

- *expatriates* (or parent-country nationals — PCNs) are citizens of the country of the parent company assigned to an overseas operation;
- *local nationals* (or host-country nationals — HCNs) are local employees who are citizens of the country in which the corporation is located overseas;
- *third-country nationals* (TCNs) are employees who are neither citizens of the country in which they are working, nor citizens of the country in which the corporation's headquarters are located.

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No definite rules exist in deciding the optimal mix of these three groups of personnel. That decision largely depends on the business philosophy and strategic agenda of the individual company; the types of production, products, and markets; the availability of its

managerial resources; and the countries where the company operates. To derive the optimal mix of the three groups, the following issues need to be examined: (a) what qualifications are required to do the job?; (b) what candidates are available in the company and in the host country?; (c) what are the specific purposes of the assignment?; (d) what impact does nationality have on the position's requirements?; (e) what is the company's policy regarding the use of expatriates versus local or third-country nationals?; (f) what will the cost be? Answers to these questions must be sought in the context of the stages of development through which the company progresses.

Stages of organizational development

Multinationals gradually progress through five stages of organizational development, including the export, direct, overseas manufacturing, international division, and global corporation stages. Each stage affects the organization's personnel deployment strategy. In the *export stage*, there is little or no need for overseas personnel. In the *direct sales stage*, the company begins to employ its own overseas sales and distribution staffs. In the *overseas manufacturing stage*, there is need for skilled and semiskilled labor which is drawn largely from the local labor force. In the *international division stage*, all three groups of personnel (PCNs, HCNs and TCNs) are now needed to manage the international production, finance, and marketing functions. Finally, in the *global corporation stage*, the company takes on a global orientation. It requires an even more international cadre of executives at this stage. The differentiation among expatriates, local and third-country nationals becomes irrelevant with the emergence of a highly qualified international staff. In the next section we consider the major requirements in designing an international compensation program.

DESIGN OF AN INTERNATIONAL COMPENSATION PROGRAM

The most commonly used design is the so-called *balance sheet approach*. According to this method, the multinational seeks to ensure that its expatriates, at a minimum, will not be

worse off for accepting an overseas assignment. Basically, the balance sheet approach begins with the employee's existing parent-company compensation (salary, benefits, and any other forms of monetary or nonmonetary remuneration). To this are added two other components: incentives to accept the foreign appointment and an equalization payment to ensure the expatriate does not suffer from foreign country differences in salary or benefits.

The entire package is composed of: (a) base salary; (b) incentive compensation, (c) premiums and allowances; (d) other forms of compensation; and (e) the thorny issue of performance pay. The *base salary program* comprises two elements: the job evaluation plan and the establishment of salary ranges. A single job evaluation plan should be used in grading the jobs of executives worldwide. The job evaluation serves to grade the relative importance of executive positions worldwide regardless of location. It is fundamental to realize that many of the elements of the pay package like incentives, allowances and so on depend on the salary grade. Salary ranges are determined by the market conditions in each country where the company has overseas operations. Therefore, separate salary ranges should be set on a country-by-country basis because using the same salary ranges worldwide would create distortions and inequity in the job evaluation process.

The *incentive compensation program* for overseas personnel presents additional challenges. Local laws and customs, along with distance from headquarters, make the design and administration of an incentive program ever more complex. Once the base salary has been determined, the company must define which incentives aptly convince the prospective executive to take the foreign assignment. One of the most used incentives has been a large *overseas premium*. In earlier times, this premium used to average 25 percent of the expatriate's base pay. Today, it hovers around 15 percent of the base salary, with an additional adjustment for higher cost-of-living positions.

Critics argue that in a global economy with world class communication, transportation systems, and accepted international business norms, much trauma and distortion associated

with an overseas assignment should no longer exist. However, the great majority of multinationals continue to pay such a premium.⁶ Salary premiums compensate the expatriate for the initial difficulties associated with adjusting to the overseas assignment. For this reason, they are often reduced and eventually eliminated when the individual remains in the overseas location.

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Salary premiums differ from *hardship allowances*. The latter are paid for hardship or dangerous postings. Hardship allowances typically range from 5 to 25 percent of base pay, with danger pay adding another 25 percent of base pay. Depending on the location, these two incentives could add as much as 50 percent to an expatriate's income.

Unlike salary premiums, allowances become continual payments to offset the higher living cost associated with an overseas assignment. Such allowances include cost of living, housing, and other forms of compensation. The most significant of these allowances is the cost of living allowance or adjustment, better known as *COLA*. COLAs enable the expatriates to maintain, as closely as possible, the same standard of living in the

6. SENKO, J.P., The foreign service premium and hardship differential. *Mobility*. May 1990, pp.10-12

foreign assignment that they would have enjoyed at home. If the expatriate comes from a major city like New York, London or Paris, where costs of living tend to be high, COLAs of 50 percent or more may be offered. The COLA is determined by calculating the costs for typical goods and services in the home location and also in the foreign location, adjusting these accordingly. One option for the company is to hire a consulting firm to estimate the cost of living in the foreign location, based on surveys of costs incurred in a standardized market basket of goods and services. Otherwise, it may want to draw on the "international citizen approach" which has been used by European companies for years and is increasingly being used by MNCs based in the United States.

According to the international citizen approach, an international basket of goods would be used across all expatriates.⁷ It would include a sample of all the goods and services that might be consumed in every country from which an organization might draw its overseas executives. Surveys would be used to determine the prices for the same basket of goods and services in all the countries to which executives might go, including the country of origin. Before accepting the overseas job, expatriates of organizations following the international citizen approach would be informed by the company that they would be expected to modify their consumption preferences.

The international citizen approach is deemed cost effective. It uses the Efficient Purchaser Index which tends to be 20% lower than the standard index. It also assumes that the executive will not need an allowance based on imported goods and services that the individual has learned to live with in the host country. This approach seems to be consistent and fair in its treatment of all types of international employees. Such a compensation policy is likely to attract and retain those candidates that will succeed.

Yet another method of estimating COLAs involves surveying the existing and former expatriates of the clients of the particular consulting firm. This method often results in a lower COLA than the international citizen approach, because only those items *actually* purchased by real expatriates are considered in the basket of goods.

In addition to the above benefits, MNCs also pay their overseas executives a housing allowance unless they provide their employees with living quarters. Multinationals also pay for relocation expenses such as the cost of moving personal and household goods, travel, and temporary lodging. Furthermore, educational allowances, especially in the form of tuition and registration fees, are also provided for the children of expatriates at the elementary and high school levels. At the college level, the only expense normally reimbursed relates to the cost of transportation to and from the school. Other allowances include annual or biennial home leave, language training, local holidays, financial counseling, local vacations, club memberships, and additional medical, travel, and life insurance.

Multinational corporations also reimburse their expatriates for foreign taxes, using an equivalent measure as that used in the home country. In general, MNCs follow one of four approaches in handling taxes on expatriate income: the *laissez faire* approach, tax equalization, tax protection, or an *ad hoc* policy.⁸ In the *laissez faire* approach, the expatriate is expected to take care of all taxes. Sometimes, this approach has been adopted by small employers just beginning their international operations. Tax equalization garners much support. Here the employer withholds the expatriate's tax obligation in the home country and then pays all the taxes in the host country. This approach may incur very high costs for the employer if the executive is assigned to a high-tax country.

In contrast to the above tax options, the tax protection strategy pays employee taxes up to the amount that would be owed in the home country, while the employer pays any excess of foreign tax above the income tax paid in the United States. If the tax rate falls below that of the foreign country, then the employee will receive the difference. Lastly, under the *ad hoc* approach, the expatriate freely negotiates with his or her employer the terms of the tax package. Given that MNCs operate in many countries subject to widely different tax rates and complex systems of taxation, they benefit from drawing on international accounting firms for advice and preparation of expatriate tax returns.

7. FREEMAN, K. and KANE, J. An alternative approach to expatriate allowances: an "international citizen". *The International Executive*, v. 37, n. 3, May/June 1995, pp.245-259.

8. STUART, P. Global Payroll: A taxing problem. *Personnel Journal*, Oct. 1991, pp. 80-90.

In addition to the above considerations, issues of *performance pay* stand out among the most difficult areas of international compensation. Whereas performance pay is generally accepted as a guiding principle in corporations headquartered in the United States, that practice does not hold in less individualistic cultures. The basic premise of performance pay is that it meet the needs of individual equity. This concept, however, may not be meaningful in other cultures. International pay systems have to pay considerable attention to cultural values when deciding whether or not to adopt this kind of compensation.

Cultural values

The widely read and influential investigation of international differences in work-related values by Geert Hofstede⁹ identified four critical dimensions of national cultures (power distance, uncertainty avoidance, individualism and masculinity). Each of these dimensions has significant implications for international pay systems.

In summarizing the concept of *power distance*, Hofstede stated that the "basic issue involved, to which different societies have found different solutions is human inequality. Inequality can occur in areas such as prestige, wealth and power, for different societies put different weights on status consideration among those areas".¹⁰

For example, Hofstede showed many Asian and Latin cultures having much higher power distance scores than those of the European and North American countries. Hofstede noted that in low power distance cultures there are positive associations with wealth and power for many individuals. The reverse can apply in high power distance cultures. Thus, societal norms would suggest stressing rewards in low power distances cultures, and coercive or referent power in high power distance cultures.¹¹ One of the findings by Cheng,¹² for example, was that contrary to conventional wisdom, Chinese employees preferred an *unequal* distribution of both financial and socio-emotional rewards.¹³

In the area of *uncertainty avoidance* (the degree to which uncertainty is tolerated in organizations), wide variation exists on criteria such as whether or not managers

should be selected on the basis of seniority or on the basis of performance. Criteria leading to the suggestion of base pay incorporating seniority would be appropriate in high uncertainty avoidance cultures, whereas performance pay would likely be more appropriate in low uncertainty avoidance countries such as the United States.

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The critical distinction between *individualistic and collectivistic cultures* also carries similar implications, with performance pay being culturally valued in individualistic cultures, and job security and seniority pay more culturally valued in collectivistic cultures.

Masculinity versus femininity. Characteristically high masculinity cultures including Japan, Mexico, Britain, and the United States, exhibit a less prevalent belief in gender equity and place a higher value in monetary rewards. On the other hand, more feminine cultures such as Denmark, Norway, the Netherlands, and Thailand, characteristically have more equitable views on gender employment and a stronger orientation toward quality of life issues than mere monetary rewards.

A recent study by Puffer and Shekshnia,¹⁴ used Hofstede's framework to argue for culturally based guidelines to assist Western

9. HOFSTEDE, Geerts. *Culture's Consequences*. London: Sage, 1984.

10. Idem, p. 65

11. Idem, p. 94.

12. CHENG, Cliff. Should Mainland Chinese be rewarded the way Americans are?. *Academy of Management Executive*. v. 1, 1996, pp 84-85.

13. Idem, p. 84.

14. PUFFER, Sheila and SHEKSHNIA, Stanislav. The fit between Russian Culture and compensation. *International Executive*. 1996, pp. 217-241.

firms in developing effective compensation plans for Russian employees. Similarly, Johannes Pennings¹⁵ found that United States' executives understand compensation in different terms from those employed by their European counterparts showing, for example, that France, with a high score on power distance, might rely on compensation differences as a means of accentuating status.¹⁶ In brief, the key issues to be addressed in this cross-cultural approach are:

- the nature of the present executive reward system;
- the perceived function of executive compensation plans;
- the link between pay and strategic performance;
- changes in compensation practices.

It should be emphasized that the international compensation program also should be tailored to meet the personnel strategy needs of the company.

INTERNATIONAL COMPENSATION PROBLEMS

Problems to be discussed in this final section arise when one or more of the following principles are not followed: (1) the compensation program does not provide for equitable treatment of expatriates, host and third-country nationals; (2) the program is not sufficiently competitive to attract, motivate, and retain qualified personnel; (3) no unusual gains or losses are associated with assignments overseas; and (4) the costs of the program are not reasonable.

Going abroad may mean that executives will be out of the career mainstream for some time. These executives may miss opportunities for promotion and development at home. On the other hand, the experience acquired in the overseas assignment might not be relevant to their careers in the long run. When they return from their overseas assignment, they may be given a lower ranked job or they may be asked to go through a retraining program or change career objectives. Therefore, an employer has to determine what compensation package has to be offered to offset *the risks* to the preservation of the executive's career.

A major consideration is the nature and size of the total remuneration package. A

salary level has to be set which, on one hand, is in line with salary scales for similar posts in the foreign country and, on the other hand, can be reconciled with the salary structure within the employing organization. Unless a proper balance is reached between these two aspects, the executive appointed could end up earning less than peers or even subordinates in the foreign country. Alternatively, the executive could end up earning far more than would be likely at home, resulting in reluctance to return at the end of the overseas assignment.

Therefore, it is not easy to find out what the contents of a benefits package should include for a job in a foreign country. In a developing country, for example, the problems of arriving at the right benefits package are even greater, since there may be no existing pattern of salary scales that can be used as a reference. It may be necessary to carry out a special survey for determining the market rate.

Also, the various constraints of a very different environment may mean adding financial inducements to fill the appointment satisfactorily. The executive to be assigned to an overseas operation is being remunerated not only to perform a given function but to adjust to many changes in living and working patterns.

Difficulties with the base salary

One of the complications in the balance sheet approach lies in exactly defining the base salary upon which to add allowances and other benefits. Some companies use the parent-country salaries as a starting point. Others use an international standard approach, while some like the international standard idea but prefer to have regional standards such as the European Community and Latin American Standards. Finally, some companies prefer to use host-country salaries as the base salary. For extended overseas assignments of long duration (three to five years), the best approach is to use the international standard approach. However, the base salary should follow the company base salary of the parent company if it is located in a high-wage developed country. On the other hand, if the assignment is of short duration (less than 3 years), then a home-country base makes more sense. Truly global companies like Coca-Cola,

15. PENNING, Johannes. Executive reward systems: a cross-national comparison. *Journal of Management Studies*. 30, 1993, pp 262-280.

16. Idem, p. 266.

prefer a regional base salary. Today, most companies compensate their expatriates based on either a home or a host country philosophy.¹⁷

Local competitiveness

The base salary must be competitive in local terms. If the base salary is wrong, everything else is wrong, because bonuses and benefit plans usually are related to base salary. This means that there must be a process to measure the competitiveness or benchmark positions in the local market. Local competitiveness can be established periodically on the basis of a total comparison of all elements of compensation, including: (a) a representative sample of important local, United States, and other foreign-controlled companies operating in similar or related industries; (b) any other locally dominant pattern-setting groups. Comparison surveys should establish both the historical patterns and the recent trends to provide the background for proper total compensation decisions.

For local employees, the competitive levels of company cash compensation programs should be compared with the historical practice of other employers in the local environment and be competitively positioned at, say, the 60th percentile level to ensure the attraction and retention of personnel from within the local market.

Some problems affecting the benefits component

Companies in all countries provide a combination of cash and benefits. In developing countries, benefits tend to be simple, limited to legally required termination indemnity payments and medical payment supplements. In developed countries, benefits may be more elaborate, providing security and income replacement on death, illness, termination of employment and retirement.

With regards to this matter, the company should make sure that *all* its foreign subsidiaries have a broad and balanced benefit package for its executives. Are benefits competitive locally? Benefit and special remuneration programs should at least match the *average* historical practice of other

employers in the local environment. Benefit and special remuneration programs that exceed the current and anticipated local trends and the introduction of innovative benefit programs should be considered only when a local operation is very profitable and the market position is secure.

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In all locations, benefits for local personnel should apply equally to all employees. Whenever this is not feasible because of collective agreements, labor requirements, or established business tradition, benefits should apply uniformly within defined groups. A crucial equity problem arises when expatriates — even in democratic countries — do not have a democratic view of eligibility for employee benefits. In their estimation, as long as the top managers have them, that suffices. One of the authors worked in Brazil for a multinational managed by executives who were unwilling to extend to lower-ranked managers the benefits they themselves enjoyed. Most countries abroad have no legislation prohibiting discrimination of this kind.

Family problems

It behoves us to note that more than half of all early expatriates' returns can be attributed to family problems.¹⁸ The inability or unwillingness of the expatriate's spouse and children to adapt to life in another country surfaces as one of the most important causes of failure. Consider sending an American male executive to a site in the Middle East. Posted to a semi-desert location, with no

17. CRANDALL, L.P. and M.I. PHELPS. Pay for a global work force. *Personnel Journal*, Feb. 1991, pp. 28-33.

18. TUNG, R. *The new expatriates: managing human resources abroad*. Cambridge, MA: Bellinger, 1988.

established township nearby, with the most rudimentary amenities, and with no chance of pursuing a Western lifestyle, this individual and his family will likely experience a dramatic cultural shock. There may be no suitable educational facilities for the children. Life can be intolerably difficult for the wife, cut off from friends, not allowed to travel unescorted, and discouraged by local customs from accompanying her husband to business social functions. Climate, custom, and law may impose different time scales and work patterns.

There may be problems with language and other unexpected difficulties. One of the authors remembers working in the Amazon jungle with its super humid climate, the abundant rain falling at the same time every day; the elevated temperatures; the exotic foods, certainly delicious but not for all tastes; and the strange but nevertheless practical customs of that vast land. He does not easily forget the day when a young American manager and his wife found a snake in their house. They called the landlord and the explanation given was that the snake, like the furniture and equipment, was part of the property. The function of the house snake rested on catching rats and mice. It took sometime for this couple to adjust to living with the slithering co-inhabitant instead of having the house infested by rats.

Given inevitable unexpected adjustments, the American executive's expectations of recompense could make that appointment an extremely expensive matter. If, in addition to the stress of operating in unfamiliar surroundings, the executive confronts trouble at headquarters, this added burden can become the straw that breaks the camel's back.

Lack of respect for acquired international experience

Most of the firms in the United States still are heavily oriented toward the domestic market. This fact is evidenced even in those companies that have a long international operation tradition. As a result, international experience has yet to be sufficiently valued. According to a study, only 12 percent of expatriates feel that their overseas assignments had enhanced their career development. In this cohort, almost two-thirds

reported that their company did not take advantage of what they had learned overseas.¹⁹

SOME INGREDIENTS TO SUCCESS

Companies that have low repatriation failure rates attribute their success to good communication with the individual and his/her family before, during and after the international assignment. According to Shilling,²⁰ successful companies offer the following observations:

- advance career planning helps expatriates know what to expect when they return;
- mentors — when used by the company — can make the expatriates feel that they are vital members of the organization;
- opening global communication channels (e.g.: e-mail, faxes) keeps expatriates up-to-date on organizational matters;
- recognizing the contributions of repatriated employees eases their reentry.

CONCLUSION

There is a natural tendency for employers to be myopic to the constraints of the real world and seek an idealized executive who quite probably does not exist. It is important that executives at headquarters understand alternatives to solving problems other than those employed at home. The paper has highlighted some of the dangers of making what appears to be a straightforward decision to send an executive overseas. A long list of costly items emerge: children's education, local accommodations, various benefits in accordance with the conditions such as pension payments, terminal gratuity, life insurance, bonus, travel costs including regular leave periods, and an abnormally high salary. Perhaps in no other area of executive compensation is an outside independent and knowledgeable view more needed than in the international scene. Without expert knowledge and advice to cope with executive recruitment, an employer might naively proceed to dispatch an executive to the new job overseas. If the wrong individual is appointed, he/she might stay the course for a few months and give up shortly thereafter, leaving the employer to start afresh in finding a successor for what is likely to be a worsened and more costly predicament. □

19. ODDOU, G.R., and MENDENHALL M.E. Successful planning for the 21st Century: how well are we grooming our future business leaders?. *Business Horizons*. Jan-Feb. 1991, pp. 26-35.

20. SHILLING, M. How to win at repatriation. *Personnel Journal*, Sept. 1993, p. 40.