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Impact of Compensation and Reward Systems on Financial and Operational Performance of Pakistani SMEs

¹Sehrish Aslam

¹MPhil Scholar, Department of Economics, University of Kotli, Azad Jammu and Kashmir,
Email: sehrishaslam451@gmail.com

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Corresponding Author:

sehrishaslam451@gmail.com

ABSTRACT

The compensation and reward systems are key determinants of employee motivation, productivity, and performance of organizations especially in the Small and Medium Enterprise (SMEs) where humans are considered a key strategic asset. SMEs in Pakistan contribute an important portion of industry and also enormous percentage of employment, but in most of the cases, informal or sporadic compensations systems are still applied in SMEs. The present research paper looks into the role of both financial and non-financial reward systems in enhancing financial performance, including profitability, sales growth, and cost efficiency, and operational performance metrics, including employee productivity, work quality, and retention. The paper is founded on secondary data which is based on journal articles, government reports, surveys of the SME sector in terms of compensation practices and performance outcomes in Pakistani business settings. The results of the literature suggest that the use of effective compensation practices, such as performance-based pay, recognition, incentive, and career growth, can help employees be more engaged and lead to better organizational performance. Nevertheless, most of the SMEs in Pakistan are struggling with the issues of limited budget, absence of strategic HR practices, and informal management procedures which are barriers to the successful implementation of rewards. The research recommends that through implementing well-defined and clear compensation systems, SMEs could tap into the potential of workforce and enhance their financial and operational performance.

Introduction

The contribution of SMEs towards the social and economic development of Pakistan is very significant. They contribute to job creation, industrial innovation, reduction of poverty and the increasing GDP. Small and Medium Enterprise Development Authority (SMEDA) estimates that SMEs represent close to 90 percent of the total number of non-agricultural private enterprises in Pakistan and almost three-quarters of the total non-agricultural labor force (SMEDA, 2022). However, most Pakistani SMEs are still struggling to retain financial viability, advance management framework, and efficiency in their operations despite their economic significance. Among the key issues is the proper management of human resources especially the compensation and reward systems, which have a direct effect on employee motivation and performance of the organization.

The term compensation describes all the financial and non-financial rewards the employees get in relation to the work (Armstrong & Taylor, 2017). The reward systems encompass monetary reward like salaries, bonuses and incentives and non-monetary rewards like recognition, flexible working arrangements, skill development and development of careers. Compensation strategies are of special importance in the SMEs context since employees frequently have to fill several functions, operate under scarce resources, and in a dynamic market setting, where organizational devotion and output are the key to business survival. Employees will also develop greater job satisfaction, organizational loyalty, and performance at work when they feel that compensation is fair and motivating (Shah and Javed, 2019).

Nevertheless, Pakistani SMEs tend to have informal, inconsistent and managerial convenience-based compensation practices that do not rely on performance benchmarking. A high number of owners of SMEs use the traditional salary, personal relationship, or ad-hoc incentives instead of strategic Human Resource Management (HRM) planning (Dar et al., 2020). Such casualness de-motivates employees, lowers productivity, and raises turnover that, in turn, have a pernicious impact on operational efficiency and financial outcomes. It is argued that with ineffective compensation systems, employees are perceived as under-recognized, and they will not be willing to put in effort; thus, the performance within the organization reduces (Raziq & Maulabakhsh, 2015). Conversely, companies that implement performance-based remuneration systems, rewards pegged on recognition, and professional learning prospects also get elevated motivation and enhanced profitability in the work place (Ali and Ahmad, 2021).

More so, the markets in which Pakistani SMEs operate are usually competitive and limited in resources. They also survive not on financial capital and technology but in the manner in which they manage human talent. The employees are central to the day-to-day operations, customer service, and innovation. The result of the compensation being adjusted according to the needs of the employees and the aims of the organization provides a favorable working atmosphere as individuals feel appreciated and putting in more effort. This helps in enhancement of operation performance indicators, including timely delivery, products quality and efficiency of the services. When motivated employees eliminate mistakes, decrease absenteeism, and increase the overall productivity, financial performance is also improved (Khan and Rasheed, 2021).

Thus, the relationship between organizational results and compensation systems is a vital area of knowledge that must be used to empower the SME sector in Pakistan. The following study will be conducted to discuss the role of compensation and reward system in the financial and functional performance of SMEs, examine the current existing challenges in the current compensation practices, and provide possible improvement opportunities that can enable SMEs to attain sustainable growth and competitive advantage. The study is based on secondary data and available literature to provide insights that may be used by the SME owners, policymakers, HR practitioners, and researcher.

Literature Review

Compensation systems and organizational performance have been issues of much debate in human resource management and organizational behavior. Generally, experts agree that compensation and reward systems define the attitude of employees, as well as the motivation at the workplace, job engagement, and the overall organizational performance (Armstrong and Taylor, 2017). Compensation is not just a source of a financial security, but it is a message of organizational value and appreciation. The compensation is even more decisive when it comes to defining the commitment and productivity of employees in the context of SMEs with interpersonal relationships and informal structures (Dar et al., 2020). Employee performance is more likely to be balanced to the performance of the organization when they feel that the compensation practices are fair, transparent, and performance-based and thus help in the operational and financial performance (Shah & Javed, 2019).

Studies indicate that compensation is not only monetary, but also non-financial. Financial rewards include salaries, bonuses, commissions, and allowances, and non-financial rewards are recognition, appreciation, career growth, flexibility of work schedules, and skills improvement (Ali and Ahmad, 2021). In SMEs in Pakistan, compensation, however, is mainly monetary and even in that case usually restricted to basic wages but without some form of incentive schemes. The high number of small companies work within a narrow financial limit and do not have the formal HR department, which contributes to inconsistent reward practices (Khan and Rasheed, 2021). Lack of performance-based rewards that are structured usually results in dissatisfaction, low commitment, and low productivity. Workers who believe that their efforts are not particularly recognized and not sufficiently rewarded will not demonstrate initiative or devotion to the company (Raziq & Maulabakhsh, 2015).

The several motivational theories substantiate the relationship that exists between compensation and employee motivation. Herzberg Two-Factor Theory underlines that salary is not the only factor that can be employed to motivate an employee, recognition, growth opportunities, and responsibility are also the much-needed options in job satisfaction (Herzberg, 1968). Likewise, the Expectancy Theory is of the view that employees are motivated when they feel that their efforts will result in favorable rewards (Vroom, 1964). Career growth is usually slow and job roles are multifunctional in SMEs, so non-financial rewards are missing and that may severely undermine intrinsic motivation. Research done regarding Pakistani SMEs shows that appreciation, respect, supportive supervision and empowerment are very useful non-financial rewards that enhance job satisfaction and job performance (Sajjad and Abbas, 2018). In such a way, financial rewards coupled with the supportive and developmental work environments can enable SMEs to motivate employees and ensure higher performance results.

Salaries also influence employee retention which is very important in terms of SME sustainability. Not only does employee turnover create an obstacle in the workflow, but it also adds expenses in terms of training and recruitment. It has been shown that fair pay is among the most potent predictors of retention (Iqbal, 2017). Competition SMEs also find it difficult to keep the talented employees particularly in Pakistan where skilled labour is hard to obtain and job mobility is increasing, because the larger organisations can offer better remuneration and benefits. In cases where SMEs offer little to no competitive remuneration or valuable rewards, the employees usually move to the corporate industry where opportunities to grow are more evident (Khawaja, 2022). On the contrary, the retention rates of SMEs and the stability of operating environments are greater in the case of performance-based incentive systems and recognition cultures.

In addition to this, compensation practices are significant in determining financial performance. Companies that have motivated employees are likely to record increased sales, greater customer satisfaction, enhanced quality of products and increased productivity (Khan and Rasheed, 2021). Performance-based pay stimulates employees to achieve organizational objectives and work towards the increase of revenue (Ali and Ahmad, 2021). Research demonstrates that SMEs with organized financial incentives and performance bonuses record a superior profit margins and level of efficiency than firms with simple wage systems (Dar et al., 2020). Compensation is not just a cost thus, an investment that has financial implications.

Reward systems also have a great influence on operational performance. When employees are motivated, they will be more committed, punctual, quality of work and collaborative (Raziq & Maulabakhsh, 2015). Employee flexibility and readiness to be responsible is crucial in operational efficiency in SMEs. Research indicates that recognition-based reward practices positively affect organizational citizen behaviors, including benefiting fellow employees and safeguarding company assets (Sajjad and Abbas, 2018). Such practices are very vital to SMEs, which often have to count on the flexibility and multi-tasking of their employees to meet the dynamic needs.

Nevertheless, studies also show that there are a number of obstacles that restrain successful implementation of compensation in Pakistani SMEs. They are financial constraints, insufficient HR experience, non-formal systems of decision-making, and cultural factors that deter performance-based assessment (Khawaja, 2022). The owners of many SMEs consider compensation as a temporary cost and not a tactical investment. Also, performance-based reward systems are often substituted with personal favoritism and biased judgments, which cause a perception of unfairness and conflict in the workplace (Dar et al., 2020). The solutions to these obstacles include organization awareness, policy reinforcement, and trainings of managers in SMEs on the current HR practice.

All in all, the literature is consistent in showing that compensation and reward systems are the key point in motivating employees, retaining them, improving the efficiency of their operations, and financial performance. In the case of the Pakistani SMEs, the implementation of structured, fair, and performance-based compensation systems is critical to attaining sustainable growth and competitiveness in the local and international market.

Methodology

The present research is based on the secondary research methodology and aims at exploring how the compensation and reward systems affect the financial and operational performance of Pakistani SME. The secondary research method is suitable in this study as there is already a lot of information available in the form of journal articles, reports on SME sector, government publications, and organization case studies. The study does not gather primary data but the findings of reputable published sources are analyzed and synthesized to create an evidence-based picture of the compensation practices in the context of the SMEs.

This research utilized the systematic search of academic databases, including Google Scholar, JSTOR, ResearchGate, Emerald Insight and ScienceDirect, to collect the data of this study. Also, small and medium enterprise development authority (SMEDA) and the Pakistan Bureau of statistics (PBS) official reports were also examined in order to get a feel of structural and economic environment of SMEs in Pakistan. The following search terms were considered as the key ones: compensation, reward systems, employee motivation, financial performance, operational effectiveness, and Pakistani SMEs. Peer-reviewed articles as well as trustworthy reports published not earlier than 2010 and not later than 2024 were included to make sure that the review is relevant to the current organizational realities.

The qualitative analysis was done using a thematic approach where patterns, arguments, and conclusions of the existing literature were determined and categorized into themes. These themes were the role of financial rewards, the impact of non-financial rewards, compensation as an aspect of motivation and retention, and the correlation of compensation strategies with the business performance outcomes. The ones that were not empirically backed, were not relevant to the industries in Pakistan and were not directly involved with the compensation and performance were left out to ensure relevance and precision.

It has some limitations to this methodology. The study is based on secondary data so it is unable to directly measure the effects of compensations, and also they do not have control over the definition of variables in original research. Variations in the size of organizations, industry and compensation schemes used in the sources reviewed can also influence comparability. Nevertheless, the virtue of this strategy is that it can generalize wide, diverse and well proved evidence and provide a holistic and contextually based insight into how compensation and reward systems relate to the performance of SMEs in Pakistan.

Data Analysis and Findings

The analysis of the data in this paper was performed with the help of a qualitative thematic story synthesis of secondary sources such as peer-reviewed journal articles, empirical case studies, SME sector reports, and organizational behavior studies. This approach did not depend on numerical or statistical analysis; instead, it focused on the discovery of repetitive and conceptual patterns and explanations across various academic materials. This was done with an aim of getting to know the effect of compensation and reward systems on the performance, stability, and competitiveness of Pakistani SMEs. The thematic synthesis found that compensation policies do not only influence financial results, but also the attitudes of employees, organizational culture, and strategic sustainability. There were four themes that were dominant throughout the literature reviewed, each of which demonstrates a unique manner in which compensation systems relate to organizational performance, namely, financial compensation, non-financial rewards, employee retention, and performance alignment.

The initial significant theme that can be noticed in the literature is the paramount significance of competitive and fair financial compensation. It was always reported that since SMEs are not very large in terms of scale, they encounter considerable trouble in providing salaries that can be comparable to the salaries offered by big domestic companies or multinational organizations operating in Pakistan. Several SMEs operate on limited budgets and unstable cash inflows especially in retail, manufacturing as well as small scale services. However, the literature has shown that employees who feel that they are not fairly paid, paid poorly or inconsistently will show a lack of commitment, lack of work intensity and lack of readiness to contribute towards organizational citizenship behaviors. Money is not the only resource to be used financially, but it is a symbolic sign of appreciation and appreciation. Salary fairness is a common aspect that the employees in an organization perceive as an indication of the respect and appreciation that the organization has towards them. Even slight increases in pay rates, including regular pay increases, open payroll schemes, or occasional performance bonuses were also discovered to have a disproportionately advantageous impact on morale and productivity. Monetary rewards, thus, are still structural elements of organizational performance, although SMEs are not always able to compete with corporate compensation.

The second thematic result is that non-monetary rewards are becoming more and more important in an environment where financial resources are scarce. Depending on the literature, there is an increasing awareness of recognition of the fact that employee motivation is not limited by salary per se; instead, intrinsic psychological rewards contribute to determining workplace engagement. These non-financial benefits consist of free communication, acknowledgment of the success publicly, the chance to improve the skills, flexible working hours, respectful management, and participation in decision-making. The size and less hierarchical nature of the SMEs uniquely puts them in the position to develop interpersonal relationships between employees and management that are close. This interpersonal intimacy, which is used to its advantage, brings the feeling of belonging, emotional stability, and self-development in the organization. Research has indicated that when employees feel valued and respected despite the absence of high financial rewards, they exhibit increased loyalty, readiness to take initiative and become tougher under pressure. Therefore, non-financial rewards act as psychological compensation systems, which strengthen emotional connection and alignment of identity with the work place.

The third theme through the analysis is the relationship that extends between compensation and employee retention that has a very high implication to the stability of the organization. The issue of employee turnover has been established to be one of the most critical problems facing SMEs in Pakistan. As the workers in SMEs tend to work with few workforce, the leaving of a few main employees can easily interfere the operations, reduce the production speed, and degrade relationships with clients.

The failure of compensation strategies to satisfy the employees, be it in financial or psychological sense, the employees tend to find jobs in larger and more established companies that have organized promotion systems and benefits. The literature indicates that turnover results in a vicious circle of reduced costs such as the costs of recruitment, the cost of training, loss of productivity during the replacement periods and knowledge loss. In comparison, those SMEs that have managed to apply fair compensation with favorable workplace conditions record high retention rates. In response, a properly crafted reward system (that is both equitable in terms of salary and supporting and encouraging employees) instills organizational loyalty and decreases the undercover costs of operation of turnover.

The fourth theme that prevails is the influence of the design of the reward system on organizational performance and strategic direction. Reward systems are behavioral indicators, they inform the employees on what activities and values are valued in the organization. In case the compensation is given without any formal manner and without performance-related criteria, the employees will feel that the system is prejudiced and unpredictable or biased by favoritism. Such impressions result in dissatisfaction, interpersonal conflict and a decrease in collaborative culture. On the flipside, where compensation systems are designed in an open-minded and attached to quantifiable performance measures, the employees get clarity on performance expectations and responsibility. This transparency enhances the value of satisfying the performance expectations, encourages moral working habits and supports congruence between personal interests and corporate goals. The transparent reward systems are therefore organizational control mechanisms that strengthen the productivity, efficiency and strategic coherence.

Table 1: Thematic overview of the reviewed literature on a larger scale

Theme	Key Observed Patterns in Literature	Strategic Implications for SMEs
Financial Compensation	Salaries signify recognition; fair pay increases morale and productivity	Maintain minimum market-aligned wage structures to prevent demotivation
Non-Monetary Rewards	Recognition, trust, and involvement improve intrinsic motivation	Utilize relational management strengths where financial capacity is limited
Employee Retention	Poor compensation triggers turnover; structured rewards increase loyalty	Invest in stable compensation to avoid costly re-training cycles
Performance Alignment	Transparent reward systems strengthen accountability and efficiency	Link rewards to measurable goals to reinforce productive behavior

Overall, the findings show that compensation and reward systems should be viewed not merely as operational expenses but as strategic investments in human capital. The strength and growth of SMEs depend heavily on cultivating a stable, motivated, and committed workforce. By balancing financial fairness with meaningful psychological rewards, SMEs can enhance performance outcomes, stabilize their labor force, and improve their competitive standing in Pakistan’s evolving economic landscape.

Conclusion

This research shows that the compensation and reward system is an important factor in determining the financial and operating performance of Pakistani SMEs. The thematic analysis of secondary data reveals that the aspects of compensation are not merely a transactional process, but a motivational, commitment, productivity determinant, and organizational stability determinant, which is strategic. Cases of high turnover, low morale and lower efficiency will be present in the SMEs when the compensation structures are poor and irregular, but when the compensation structures are equitable and balanced to the efforts of the employee, the SMEs will gain by having increased employee retention, enhanced productivity and continuity in operations. The paper also indicates that despite the financial limitations of most SMEs to pay competitive wages, the flexibility of their structure is also unique and enables them to introduce powerful non-monetary incentives that can levels of work satisfaction and loyalty to a considerable extent.

It is hence clear that compensation and reward systems should be perceived as an investment and not expenses. Performance and satisfaction of the workforce determines the success and growth of SMEs and compensation is one of the major factors that affect the results. A combination between monetary and non-monetary rewards is necessary in order to accomplish the sustainability and competitiveness in the long term. The importance of enhancing compensation systems is not only helpful to the individual business, but also the overall economic growth, where SMEs form the foundation of the business world in Pakistan. Considered, equitable, and performance-based reward systems are therefore core in enhancing sustainability and expansion prospects of SMEs in Pakistan.

Recommendations

According to the findings, this research advises that Pakistani SMEs should implement a well-organized and transparent compensation model that effectively communicates pay rates, performance standards and rewards procedures. Where there are limited financial resources, SMEs are advised to make sure that salaries are set at the minimum market standards to avoid the loss of talents and consequent operational crises due to turnover. Among other things, the non-financial reward practices that the SMEs should embark on include employee recognition, skill development, supportive supervision, inclusive decision-making, and positive work environment in addition to monetary compensation. The strategies are not costly, as they only need a little amount of money, but their impact on employee morale and commitment to the organization is huge.

In addition, to increase accountability and productivity, SMEs are advised to set reward and compensation systems according to the measurable organizational objectives. Training SME owners and managers on the contemporary practices of the human resource, compensation planning, and employee motivation should be done by institutions that support policy, like SMEDA and business development centers. The next research must take primary data collection to measure the effects of compensation in certain industries and geographical areas that will provide a more in-depth understanding of the industry-specific issues. The compensation practices in Pakistan need to be reinforced in order to make the SMEs compete successfully, retain talents and attain sustainable financial growth in the changing economic environment in Pakistan.

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