Employee Incentive Mechanisms in Small and Medium-Sized Enterprises and Strategies for Their Optimization

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Abstract: Constrained by their operating scale, financial capacity, and managerial foundations, small and medium-sized enterprises (SMEs) frequently encounter problems in employee incentive management, including ambiguous compensation standards, one-dimensional performance appraisal, limited opportunities for career advancement, and largely symbolic nonfinancial incentives. Effective incentives should be based on the alignment of job value, employee needs, and organizational objectives. Enterprises should improve their compensation and performance management systems, establish differentiated career development pathways, expand appropriate employee empowerment, strengthen recognition and communication, and ensure effective policy implementation through dynamic evaluation and managerial training. These measures can help SMEs gradually develop sustainable incentive mechanisms that integrate material rewards with employee development.

Keywords: small and medium-sized enterprises; employee incentives; compensation management; performance appraisal; career development

Introduction

Small and medium-sized enterprises are characterized by relatively small organizational structures and flexible operating models. They play an important role in job creation and market innovation. Because SMEs employ relatively few people, each position can exert a substantial influence on business operations. The departure of key employees may disrupt customer relationships, result in the loss of technical expertise, and increase the workloads of remaining team members. Establishing a stable and reasonable employee incentive mechanism is therefore an important managerial task for SMEs seeking to retain talent and improve organizational efficiency.

The incentive resources available to SMEs are generally limited. Their compensation levels, training investment, and opportunities for promotion are often difficult to compare directly with those offered by large enterprises. Some SMEs rely on temporary bonuses, verbal promises, or managers' personal relationships to maintain employee motivation, while lacking clearly defined job standards and performance rules. When business conditions change, these incentive measures can easily be discontinued, thereby weakening employees' confidence in institutional stability and organizational fairness.

In the fourth quarter of 2024, China's SME Development Index stood at 89.0, an increase of 0.1 points from the third quarter. During the same period, the cost, financing, and labor indices each declined by 0.1 points [1]. Although operating conditions improved to some extent, pressures associated with costs, financing, and employment persisted. SMEs must therefore design incentive arrangements that balance their cost-bearing capacity with employee needs. They should neither rely exclusively on wage increases nor disregard employees' legitimate expectations of equitable compensation on the grounds of operating pressure.

1. Basic Components of Employee Incentive Mechanisms in SMEs

1.1 Principal Components of Employee Incentives

Employee incentives refer to the process through which an enterprise uses compensation, performance management, career development, empowerment, recognition, and organizational culture to encourage employees to commit themselves to their work and contribute to organizational objectives. The outcomes of an incentive system are reflected not only in short-term work intensity but also in work quality, willingness to innovate, organizational identification, and long-term retention.

Material incentives include base salaries, performance bonuses, allowances, benefits, and profit-sharing arrangements, all of which directly affect employees' income and financial security. Developmental incentives include training, job rotation, career pathways, and professional certification, which primarily address employees' needs for competence development and career advancement. Job-related incentives involve autonomy, task completeness, and opportunities to participate in decision-making. Nonfinancial incentives include public recognition, timely praise, a sense of team belonging, fairness, and respect.

Different incentive measures should be mutually reinforcing. Base salaries reflect the value of particular jobs, performance bonuses recognize contributions made during a specific period, training and promotion create expectations of future development, and empowerment and recognition improve the employee experience. If an enterprise provides bonuses without establishing a fair performance appraisal system, its financial investment may still fail to produce the expected outcomes.

1.2 Operational Characteristics of Incentive Mechanisms in SMEs

SMEs generally have fewer organizational levels, and the distance between business owners and employees is relatively limited. Communication and decision-making adjustments can therefore be undertaken comparatively quickly. Managers can promptly understand employees' performance and practical difficulties and can use flexible measures such as immediate rewards, job reassignment, and participation in specific projects.

However, a small organizational scale may also cause institutional arrangements to depend excessively on individual managers. Job responsibilities may change frequently in response to business developments, and employees are often required to perform cross-departmental tasks. Fixed job descriptions may consequently fail to cover all their duties. If business owners evaluate employees primarily on the basis of personal impressions, interpersonal proximity and recent performance can exert an undue influence on decisions concerning bonuses and promotion.

SMEs also offer relatively few managerial positions, making conventional promotion through the managerial hierarchy insufficient to meet the developmental needs of all employees. Incentive mechanisms should therefore provide professional, technical, and project-based career pathways. Even if employees do not enter management positions, they should be able to achieve higher job grades, compensation, and professional influence through improvements in their capabilities.

2. The Current Environment for Employee Incentives in SMEs

2.1 The Influence of Business Fluctuations on the Allocation of Incentive Resources

Orders, payment collection, and profits in SMEs may fluctuate considerably in response to market changes. Increases in fixed compensation create long-term costs, whereas complete reliance on variable compensation can undermine income stability. Enterprises must distinguish between basic income protection and the sharing of business returns. While ensuring that base salaries are paid in full and on time, they may link a proportion of employee rewards to team performance, project outcomes, and overall business results.

Survey data released by the China Association of Small and Medium Enterprises indicate that, in the fourth quarter of 2024, enterprises operating at full capacity accounted for 39.4% of the surveyed sample, an increase of 6.7 percentage points from the third quarter. Enterprises operating at between 75% and 100% of capacity accounted for 14.7%, while enterprises that had not commenced operations accounted for 8.6% [1]. The substantial differences in operating conditions among enterprises demonstrate that incentive systems cannot simply be copied from a standardized model.

Business fluctuations also affect employee expectations. Frequent changes to bonus standards, failures to honor reward commitments, and uncertainty regarding payment dates can undermine the credibility of an incentive system. When designing rewards, enterprises should clearly specify the conditions under which they will be paid and reserve an appropriate budget for such payments. Employee rewards should not be based entirely on uncertain future earnings.

2.2 The Coexistence of Wage Growth and Employees' Living Needs

According to the National Bureau of Statistics of China, the average annual wage of employees in private urban entities nationwide was RMB 69,476 in 2024, representing an increase of RMB 1,136 over 2023 and a nominal growth rate of 1.7%. On a comparable basis, wages increased by 4.0% [2]. Because the statistics for private entities cover a large number of micro and small enterprises, they can provide a useful reference for SMEs assessing labor-market conditions.

Table 1. Data Related to SME Operations and Wages in Private Urban Entities, 2023–2024

Indicator	2023 or Q3 2024	2024 or Q4 2024	Change
Average annual wage of employees in private urban entities	RMB 68,340	RMB 69,476	Nominal increase of 1.7%
SME Development Index	88.9	89.0	Increase of 0.1 points
Proportion of enterprises operating at full capacity	32.7%	39.4%	Increase of 6.7 percentage points
Proportion of enterprises operating at 75%–100% of capacity	13.6%	14.7%	Increase of 1.1 percentage points
Proportion of enterprises operating below 50% of capacity	22.2%	17.5%	Decrease of 4.7 percentage points
Proportion of enterprises not operating	10.1%	8.6%	Decrease of 1.5 percentage points

Note: The wage data correspond to 2023 and 2024, whereas the SME Development Index and operating-capacity data correspond to the third and fourth quarters of 2024, respectively. Because the indicators were compiled using different statistical methodologies, they should not be interpreted as establishing direct causal relationships.

Source: Compiled from publicly available wage statistics released by the National Bureau of Statistics of China and survey data released by the China Association of Small and Medium Enterprises [1–2].

Average wages cannot be used directly as the compensation standard of an individual enterprise because actual income is affected by region, industry, position, and employee competence. SMEs may determine appropriate compensation ranges by considering local wage levels for comparable positions, their own ability to pay, and the internal value of each job, thereby maintaining basic labor-market competitiveness.

Employees are concerned not only with the amount of their wages but also with income stability, timely payment, and distributive fairness. Unexplained pay differences among employees holding equivalent positions and the long-term reliance on managers' ad hoc decisions regarding performance bonuses can easily cause dissatisfaction. Compensation incentives must therefore simultaneously address external competitiveness, internal equity, and differences in individual contributions.

2.3 Diverse Demands Arising from Changes in Workforce Composition

The workforces of SMEs may include technical specialists, sales personnel, production workers, managers, and newly recruited employees. Considerable differences exist in both the outputs and needs associated with these positions. Sales personnel value clear commission rules and access to customer resources; technical employees are more concerned with professional development and project autonomy; production workers attach greater importance to income stability and working conditions; and managers focus on the relationship between their responsibilities, authority, and long-term career development.

Employees' career stages also influence their incentive needs. Newly recruited employees require workplace guidance, skills training, and clearly defined standards. Experienced employees are more concerned with salary growth, professional development, and participation in decision-making. Key employees may place greater emphasis on long-term returns, project responsibility, and career security.

Zhao et al. observed that human resource management has gradually evolved from administrative personnel management into an integrated approach encompassing employee capabilities, organizational strategy, and employment relationships [3]. SME incentive mechanisms should therefore recognize differences among employees and avoid applying an identical reward model to every position.

3. Problems Affecting Employee Incentive Mechanisms in SMEs

3.1 Insufficient Fairness and Transparency in Compensation and Performance Systems

Some SMEs do not conduct systematic job analyses. Compensation is determined primarily through entry-stage negotiations, historical standards, or business owners' personal judgments. Consequently, employees performing the same job may receive substantially different incomes because they joined the enterprise at different times, while employees assuming greater responsibilities may not receive corresponding compensation.

Another problem is the excessive simplicity of performance indicators. Enterprises often use sales revenue, production output, or project progress as their principal indicators while neglecting quality, customer satisfaction, collaboration, and risk control. To achieve short-term quantitative targets, employees may omit necessary procedures or reduce their cooperation with other team members.

The relationship between performance results and compensation is also frequently unclear. Employees may not know how much of a bonus corresponds to each appraisal rating, while managers may change the standards after the appraisal period has ended. When appraisal processes lack communication and appeal procedures, employees cannot clearly understand their deficiencies, and performance management deteriorates into little more than a tool for distributing bonuses.

Su argued that compensation management must coordinate job value, individual competence, performance contributions, and external market levels [4]. If SMEs lack a basic compensation structure, even relatively generous bonuses may fail to establish a lasting sense of fairness.

3.2 Inadequate Developmental Opportunities, Empowerment, and Nonfinancial Incentives

Some SMEs believe that systematic training is costly and that employees may leave after receiving it. They therefore provide few structured training opportunities. Newly recruited employees rely primarily on temporary guidance from colleagues, and no clearly defined pathway is available for skills development. When employees repeatedly perform the same tasks over an extended period without perceiving any improvement in their capabilities or career prospects, their intention to leave may increase.

Insufficient empowerment also weakens employee motivation. Managers may fear losing control and therefore concentrate authority over customer communication, expenditure approval, and project adjustments in their own hands. Employees bear responsibility for their work but lack the corresponding decision-making authority. When problems arise, they must repeatedly seek approval, adversely affecting both operational efficiency and their sense of responsibility.

Nonfinancial incentives often remain limited to verbal praise and employee recognition activities. When the criteria for rewards are unclear or recognition is repeatedly given to only a small group of employees, such measures lose their motivational effect. Managers may communicate with employees only when errors occur and provide little timely feedback on routine contributions, making it difficult for employees to recognize the organizational value of their work.

4. Strategies for Optimizing Employee Incentive Mechanisms in SMEs

4.1 Establishing a Compensation System Integrating Job Value and Performance Contributions

Enterprises should analyze job responsibilities, workload, skill requirements, and exposure to responsibility-related risks, and then classify positions into appropriate job grades. Job grades should determine base-pay ranges, while employees' competence, experience, and performance should determine their precise position within those ranges. This approach can reduce the excessive influence of recruitment negotiations and personal relationships on compensation.

The compensation structure may consist of base salaries, position-related allowances, performance bonuses, and employee benefits. Base salaries provide income stability; position-related allowances compensate for specialized skills or particular working conditions; and performance bonuses reflect individual and team contributions. When business performance is strong, enterprises may also introduce project-based rewards, annual profit-sharing arrangements, or long-term incentives for key employees.

Performance indicators should be adapted to the characteristics of each position. Sales positions may be evaluated according to sales receipts, customer retention, and compliance; production positions according to output, quality, and safety; technical positions according to project completion, problem-solving, and knowledge accumulation; and administrative or support positions according to timeliness, accuracy, and the quality of internal services.

The number of indicators should remain manageable. Three to five principal indicators may be selected for each position, with their calculation methods, data sources, and evaluation cycles clearly specified. Objectives should be confirmed with employees before the appraisal period begins, and the results and areas requiring improvement should be explained after the appraisal has been completed.

4.2 Developing Differentiated Employee Development Mechanisms

SMEs can establish three categories of career pathways: managerial, professional, and project-based. Employees with organizational and coordination capabilities may enter the managerial pathway; professional employees may advance according to their skill levels; and leaders of cross-departmental projects may obtain higher grades and rewards on the basis of project outcomes.

Training should address practical workplace problems. Enterprises can control training costs by using workplace mentoring, case reviews, internal knowledge-sharing sessions, short external courses, and job rotation. Skills inventories should be established for key positions. Employees who complete the required training and pass practical assessments should receive the corresponding skills grade and compensation adjustment.

New employees require a clearly defined onboarding and development plan covering job standards, business processes, and phased objectives. Experienced employees may be assigned more challenging responsibilities, such as improvement projects, the training of new recruits, and customer service. Key employees may participate in business planning, product innovation, and team development.

Training agreements and career development discussions can stabilize the expectations of both enterprises and employees. Enterprises may establish reasonable service periods on the basis of training costs, employee contributions, and job characteristics. However, such agreements should not be used to impose unreasonable restrictions on normal labor mobility.

4.3 Improving Empowerment, Recognition, and Organizational Communication

Employee empowerment requires the clear definition of the scope of authority, expected objectives, and risk boundaries. Project leaders may be permitted to reallocate resources within an approved budget; customer service personnel may resolve complaints involving amounts below a specified limit; and technical employees may select specific solutions. Managers should retain decision-making authority over major matters while reducing repetitive approval procedures in routine work.

Employee recognition should be specific, timely, and directly associated with actual contributions. When praising employees, managers should explain what they accomplished, what problems they resolved, and what value their work created. Public recognition is appropriate for contributions to a team, whereas matters involving personal privacy or work-related mistakes should be addressed through private communication.

Enterprises may also establish channels for improvement proposals, competitive project applications, and employee meetings. Employees whose feasible proposals generate tangible results should receive bonuses, formal recognition, or opportunities to participate in projects. Employee involvement in institutional improvement can strengthen their understanding and acceptance of organizational rules.

Organizational communication should maintain a reasonable degree of information transparency. Business owners may periodically explain the enterprise’s orders, costs, and operational priorities so that employees understand the basis for performance targets and changes to bonuses. Information concerning individual wages, positions, and personal appraisals should, however, be disclosed only within an appropriate scope to prevent transparent management from resulting in the exposure of personal information.

5. Safeguards for Implementing Incentive Mechanisms

5.1 Strengthening Performance Feedback and Dynamic Adjustment Systems

Performance management should encompass objective setting, ongoing communication, results appraisal, and improvement planning. Managers should not wait until the end of an appraisal period before identifying problems. When work objectives or market conditions change substantially, managers and employees should record the reasons for the change and revise the relevant indicators accordingly.

A review procedure should be available when employees disagree with their appraisal results. The review panel may consist of the employee's direct supervisor, a higher-level manager, and the person responsible for human resource management. The appraisal should be reconsidered on the basis of work records and relevant data. Smaller enterprises may use simplified procedures, but the original evaluator should not have sole authority to make the final decision.

Incentive systems should be evaluated regularly. Enterprises may monitor employee turnover, retention in key positions, performance distributions, training completion, and employee satisfaction. If performance does not improve after bonuses have been increased, the problem may lie in indicator design or working conditions. Similarly, a decline in employee satisfaction should not automatically be attributed to compensation; management practices, workload, and development opportunities should also be examined.

5.2 Strengthening Managerial Capabilities and Organizational Culture

Managers in SMEs often assume responsibility for both business operations and personnel management. As a result, they may emphasize task completion while neglecting communication. Enterprises should strengthen managerial training in objective setting, performance interviews, conflict resolution, and employee coaching. Managers' ability to explain organizational rules fairly and provide timely feedback directly affects the effectiveness of employee incentives.

Organizational culture must be reflected in everyday management practices. If an enterprise emphasizes cooperation, team contributions should be incorporated into its performance indicators. If it values innovation, it should tolerate reasonable experimentation and provide resources for improvement proposals. If it emphasizes integrity, managers must first honor their commitments regarding compensation, bonuses, and employee development.

Zhao, Zhang, and Cheng proposed that human resource management should be integrated with organizational strategy, job systems, and employee development [5]. Employee incentive mechanisms in SMEs should likewise serve their business objectives. Start-up enterprises may place greater emphasis on project outcomes and shared growth, whereas enterprises entering a stable stage of development should strengthen job standards, compensation structures, and long-term career development systems.

Conclusion

Employee incentives in SMEs constitute a comprehensive management activity involving compensation, performance, development, empowerment, recognition, and organizational relationships. Limited financial resources do not mean that an enterprise can use only low-cost incentives, while high expenditure on compensation does not necessarily produce positive outcomes. Institutional fairness, clear objectives, timely feedback, and visible opportunities for development all influence employees' work engagement and retention decisions.

SMEs should improve their compensation structures on the basis of job value, establish performance indicators suited to the characteristics of different positions, and create managerial, professional, and project-based development pathways. Appropriate empowerment, specific recognition, and communication concerning business conditions can strengthen employees' sense of responsibility. Performance review procedures, dynamic evaluation, and managerial training can provide safeguards for effective implementation. Only when different incentive measures are aligned with an enterprise's operating capacity can it develop a stable, credible, and sustainable employee incentive mechanism.

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