

# Transformational Versus Transactional Leadership: Implications for SME Management

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**Abstract:** Leadership styles play a crucial role in shaping the performance and outcomes of Small and Medium-sized Enterprises (SMEs). This paper discusses two prominent leadership styles, transactional and transformational leadership, on various organizational aspects within the SME context. Transactional leadership, characterized by structured exchanges based on rewards and penalties, is found to positively influence employee performance, operational efficacy, and strategic success in diverse settings. While transactional leadership is noted for its direct impact on organizational processes, its relationship with innovation and learning capabilities is nuanced. On the other hand, transformational leadership, focusing on inspiration and motivation through a shared vision, has a significant positive influence on innovation, employee performance, and retention in SMEs. Studies highlight how transformational leadership fosters a culture of trust, innovation, and continuous improvement, impacting areas such as knowledge sharing, organizational citizenship behavior, and sustainability practices. The findings stress the critical role of both leadership styles in driving success within SMEs, emphasizing the need to consider specific practices, sectoral contexts, and organizational environments for optimal impact.

**Keywords:** Small and Medium-sized Enterprises (SMEs), Transactional leadership, Transformational leadership, Organizational culture, Employee performance, Innovation.

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## 1. Introduction

Small and Medium-sized Enterprises (SMEs) form the backbone of many economies, playing a crucial role in driving innovation, creating employment opportunities, and fostering economic growth. Effective leadership plays a central role in shaping organizational culture, fostering employee engagement, and driving business success in SMEs. The leadership style adopted by SME managers can significantly impact the way teams operate, innovate, and ultimately achieve their goals.

Among various leadership theories, two prominent styles often discussed in the context of SME management are transformational and transactional leadership which was introduced by Burns (1978). Transactional leadership focuses on clear expectations, rewards, and consequences, while transformational leadership emphasizes inspiration, vision, and empowerment.

## 2. Transformational Versus Transactional Leadership

### 2.1. Transactional Leadership

Transactional leadership is a traditional style that emphasizes clear expectations, rewards, and consequences between leaders and their followers (Bass, 1985). Leaders under this approach set specific goals and provide incentives or sanctions based on performance, creating a transactional relationship within the organization. This style is characterized by its focus on structured exchanges, where rewards are granted for meeting predefined objectives, and penalties are enforced for failing to do so.

Studies on transactional leadership presents a coherent narrative regarding its influence on various organizational outcomes, particularly in small and medium-sized enterprises (SMEs) in different contexts. Abdelwahed, Soomro, and Shah

(2023) establish a significant positive relationship between transactional leadership and employee performance in Pakistan, noting the mediating role of entrepreneurial passion. Their findings suggest that leaders applying transactional practices, such as rewards for performance, can significantly enhance employee motivation and effectiveness. This theme of motivation is echoed by Kabiru and Bula (2020), who also find a positive association between transactional leadership and employee performance in Kenyan commercial banks.

In addition to employee performance, the impact of transactional leadership on organizational processes is prominent in the work of Langton and Mafini (2022), who analyze the role of transactional leadership in supply chain management within South African manufacturing SMEs. Findings indicate that management by exception—a core component of transactional leadership—has a positive effect on supply chain execution and customer service, albeit with a limited overall impact on broader strategic aspects. Similarly, Tran et al. (2020) examine the effects of transactional leadership on supply chain quality management in the Vietnamese tourism sector, finding a positive relationship with business performance. However, they note that supply chain quality management does not mediate the relationship, indicating that transactional leadership's impact is direct yet may depend on additional contextual factors.

Study conducted by Odoro (2023) in the private sugar manufacturing sector in Kenya reveals a significant positive relationship with strategic success but finds that organizational culture does not moderate this relationship, suggesting that transactional leadership alone can drive effective strategic outcomes. In contrast, Thahira, Tjahjono, and Susanto (2020) conclude that while transactional leadership does not directly enhance organizational learning capability, it significantly influences innovative outcomes. This finding underlines the complexity of transactional leadership's role in fostering innovation, implying that the

learning environment is critical for translating transactional leadership into innovative practices.

Lastly, Mendoza Solis et al. (2023) explore the dimensions of transactional leadership within Mexico's maquiladora industry. Findings suggest that there is a strong relationship between the dimensions of transactional leadership and social performance, except for the passive management by exception dimension, which shows no direct or positive effect on social performance.

The studies emphasize that transactional leadership significantly influences employee performance, operational efficacy, and innovation within various organizational contexts. While the effectiveness of transactional leadership is consistently acknowledged, the studies also reveal differences regarding its application, suggesting that the impact of transactional leadership can vary based on sector, specific practices employed, and the broader organizational environment.

## 2.2. Transformational Leadership

Transformational leadership is a leadership style that focuses on inspiring and motivating followers to achieve higher levels of performance and morale through a shared vision and common goals (Bass, 1985). Key traits of transformational leaders include charisma, vision, intellectual stimulation, and individualized consideration. These leaders are often seen as role models who empower their teams to reach their full potential by fostering a culture of trust, innovation, and continuous improvement.

Studies on transformational leadership in small and medium-sized enterprises (SMEs) reveals a significant positive impact on various organizational outcomes, including innovation, employee performance, and retention. Jabeen (2022) establishes that transformational leadership is the most influential leadership style in SMEs, emphasizing that it enhances organizational survival and innovation, especially through the component of intellectual stimulation. This foundational understanding of transformational leadership highlights its critical role in creating a conducive environment for growth and adaptation within these organizations.

In examining the mechanisms by which transformational leadership influences innovation and knowledge sharing, AFRIYIE et al. (2020) and Cortes & Herrmann (2020) provide contrasting insights. While AFRIYIE et al. (2020) find that transformational leadership does not moderate the relationship between innovation and knowledge sharing, Cortes & Herrmann (2020) argue that transformational leaders enhance innovation by promoting employee participation and social capital. This suggests that transformational leadership's effectiveness may depend on specific organizational contexts and the dynamics of employee engagement. Both studies reinforce the idea that transformational leadership is vital for fostering a culture of innovation within SMEs.

Employee performance and organizational behavior further highlight transformational leadership's significance. Purwanto (2022) connects transformational leadership with organizational citizenship behavior (OCB) and performance, finding that OCB partially mediates the relationship between transformational leadership and performance. Similarly, Saeed & Jun (2022) and Raziq et al. (2021) explore transformational leadership's influence on employee retention and turnover intention, demonstrating that transformational

leadership can effectively reduce turnover intention through mechanisms like affective organizational commitment and job satisfaction. Raziq et al. (2021) emphasize the importance of communication as a moderating factor in these relationships, indicating that effective communication can enhance the positive outcomes of transformational leadership.

The intersection of transformational leadership with sustainability and innovation is increasingly prominent. Some studies highlight transformational leadership's role in promoting environmental, social, and governance (ESG) performance through organizational innovation. According to Zhu & Huang (2023), transformational leadership not only directly affects ESG performance but also does so indirectly via innovation, establishing transformational leadership as crucial for sustainable practices within SMEs. Begum et al. (2020) similarly identify organizational learning as a mediator between transformational leadership and sustainable organizational innovation, emphasizing the strategic significance of transformational leadership in fostering a culture of continuous improvement.

These studies underscore the importance of transformational leadership as a driving force in promoting innovation, performance, and employee retention within SMEs. However, the studies also indicate a complexity in how transformational leadership impacts these outcomes, shaped by various mediating and moderating factors. The focus on sustainability and its relationship with transformational leadership represents a new and essential dimension of this discourse.

## 2.3. Transformational and Transactional Leadership

Studies on transformational and transactional leadership in Small and Medium-sized Enterprises (SMEs) reveals diverse insights into their impacts on organizational performance. In Indonesia, Feranita et al. (2020) found that transformational leadership significantly enhances SME innovation and performance, while transactional leadership indirectly contributes to performance. In Manado, Dipuro et al. (2022) highlighted the partial effect of transactional leadership on employee creativity, contrasting with the negligible impact of transformational leadership in fostering creativity.

Exploring financial outcomes, Mwakajila & Nyello (2021) in Tanzania demonstrated that transformational and combined leadership styles positively influence SME financial performance, while transactional leadership has a detrimental effect. Khalil et al. (2022) in Malaysia emphasized the positive effects of transformational, charismatic, and visionary leadership on organizational effectiveness and financial performance, advocating for suitable leadership style selection tailored to SME needs.

During crises like the Covid-19 pandemic, findings underscored the effectiveness of transformational leadership over transactional leadership in managing SMEs amidst challenges (Singh et al., 2022). Studies by Cui et al. (2022) in China and Rumijati (2020) highlight the positive impact of leadership styles on innovation performance and the significant influence of transformational leadership on organizational performance through fostering a learning culture.

Paudel (2020) identified the mediating role of entrepreneurship orientation in the relationship between leadership styles and business performance, with transformational leadership emerging as a stronger predictor.

Rumijati et al. (2024) found that both leadership styles affect organizational learning. Transformational leadership has significant positive influence on organizational performance, while transactional leadership shows no direct impact on performance.

Results in Chinese SMEs reveal that transformational leadership positively (negatively) moderates the relationship between flexibility (control) culture and innovation capability, while transactional leadership positively moderates the relationship between control culture and innovation capability (Wang & Huang, 2022).

These studies on transformational and transactional leadership in Small and Medium-sized Enterprises (SMEs) reveals a complex interplay of leadership styles with various organizational outcomes. While transformational leadership emerges as a consistent driver of innovation, organizational performance, and knowledge management across different contexts, transactional leadership's effects appear more nuanced, with partial impacts on employee creativity and financial performance. The mediating role of factors such as entrepreneurship orientation, organizational culture, and team dynamics further shapes the relationship between leadership styles and SME success. In times of crisis, the effectiveness of transformational leadership becomes pronounced, highlighting its crucial role in guiding SMEs through challenges. The synthesis underscores the importance of understanding the distinct impacts of transformational and transactional leadership on different facets of SME operations, emphasizing the need for tailored leadership approaches to foster growth, drive innovation, and ensure sustainability in the dynamic landscape of small and medium-sized enterprises.

### 3. Implications for SME Management

In Small and Medium-sized Enterprises (SMEs), the leadership style adopted by managers plays a crucial role in determining the organization's success and sustainability. Understanding the implications of different leadership styles and their impact on employee engagement, motivation, and organizational culture is paramount for SME management seeking to foster growth and innovation within their companies.

The importance of leadership style in SME success cannot be overstated. Effective leadership sets the tone for the entire organization, influencing employee morale, productivity, and overall performance. A well-suited leadership style can inspire and motivate employees, drive innovation, and create a positive work environment conducive to achieving strategic objectives and sustained growth in SMEs.

To optimize outcomes, SME managers can consider integrating elements of both transactional and transformational leadership styles. By combining the structured approach of transactional leadership with the visionary and inspirational aspects of transformational leadership, managers can create a balanced leadership approach that fosters both short-term results and long-term growth. Strategies for integrating these elements may include setting clear goals and expectations (transactional), while also inspiring and empowering employees to contribute creatively to achieving the organization's vision (transformational).

When selecting and adapting leadership styles to fit their organization's needs, SME managers should consider several key considerations. Firstly, understanding the organizational culture, values, and goals is essential in determining the most suitable leadership approach. By aligning the leadership style

with the organization's values and objectives, managers can foster a cohesive and purpose-driven work environment.

Secondly, flexibility and adaptability are crucial in navigating the dynamic business landscape characteristic of SMEs. Managers should be open to adjusting their leadership style based on changing circumstances, employee needs, and market conditions. A one-size-fits-all approach may not be effective in the diverse and evolving context of SMEs, highlighting the importance of being responsive and attuned to the organization's requirements.

Moreover, investing in leadership development and training programs can equip managers with the skills and knowledge needed to effectively implement various leadership styles and strategies. Continuous learning and improvement in leadership capabilities can enhance managerial effectiveness, employee engagement, and organizational performance in SMEs.

The implications for SME management underscore the significance of leadership style in driving organizational success and shaping the culture and performance of the organization. By integrating transactional and transformational elements, considering organizational needs, and adapting leadership styles thoughtfully, SME managers can create a conducive environment for growth, innovation, and long-term success within their organizations.

### 4. Conclusion

The findings emphasize the critical importance of considering specific leadership practices, sectoral contexts, and organizational environments when implementing leadership styles in SMEs. Both transactional and transformational leadership styles have distinct impacts on organizational processes, employee engagement, and strategic outcomes. While transactional leadership drives operational efficiency and performance, transformational leadership is instrumental in fostering innovation, employee retention, and sustainability practices.

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