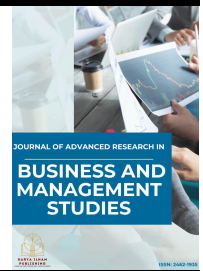




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# The Influence of Leadership Styles on Small Business Performance in Malaysia: A Conceptual Paper

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### ABSTRACT

Small and Medium Enterprises (SMEs) play a crucial role in Malaysia's economic development; however, sustaining performance in the increasingly volatile post-COVID-19 environment remains a significant challenge. Leadership style is widely recognised as a key determinant of organisational outcomes, yet prior empirical studies report inconsistent findings regarding its influence on SME performance. This paper develops a conceptual framework to examine how transformational and transactional leadership styles affect small business performance in Malaysia. Drawing on transformational leadership theory, transactional leadership theory, and contingency theory, the framework explicates the mechanisms through which specific leadership behaviours—namely idealised influence, inspirational motivation, intellectual stimulation, individualised consideration, contingent reward, and management-by-exception—shape performance outcomes in SMEs. By synthesising fragmented empirical evidence and contextualising leadership-performance relationships within the Malaysian SME setting, this paper contributes theoretically by clarifying why different leadership styles may produce varying performance effects. The proposed framework offers guidance for future empirical testing and provides theoretically grounded insights for entrepreneurs and policymakers seeking to enhance SME competitiveness and sustainability.

## 1. Introduction

Small and Medium Enterprises (SMEs) are widely recognised as the backbone of economic development in many countries, including Malaysia. SMEs significantly contribute to the Gross Domestic Product (GDP), job creation, community development, and the reduction of economic disparities [1]. According to SME Corp Malaysia [2], SMEs play a significant role in Malaysia's economy, underscored by their substantial contributions to GDP, employment, and exports. In 2024, SMEs accounted for approximately 39.5% of Malaysia's GDP, substantially contributing 14.3% to total

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exports. Furthermore, 96.1% of registered business establishments were classified as micro, small, and medium enterprises (MSMEs), with 28.2% categorised as small-sized businesses. These statistics highlight the essential function of SMEs in driving economic growth and job creation.

Despite their overall contribution, the performance of individual small firms remains relatively low. This issue has been widely debated among academics and policymakers [1]. Recent reports indicate that more than 70% of SMEs in Malaysia have been adversely affected by economic uncertainty, particularly in the post-COVID-19 period [2,3]. Consequently, the government has introduced various policies to enhance SME performance, especially among small businesses [4].

Business performance is a key concern for stakeholders, including owners, investors, suppliers, and employees. Strong performance enables firms to generate wealth, create jobs, and sustain competitiveness [5,6]. Conversely, underperforming firms often face financial distress and lose competitiveness. Therefore, firms must continuously monitor and adapt their strategies to maintain performance in a dynamic business environment [1,7].

Past research has identified several factors that influence business performance, among which leadership style is considered critical [8,9]. Entrepreneurs, as firm leaders, must adopt effective leadership styles to ensure success [10]. In complex and volatile environments, strong and authentic leadership becomes indispensable [11-13]. Studies have shown that leadership style significantly affects a firm's success or failure [14]. Two dominant styles—transformational and transactional leadership—are commonly practised by entrepreneurs [8,15,16]. These styles are not mutually exclusive; leaders may adopt one or both depending on organisational needs [17]. Aligning leadership style with organisational context is essential for improving performance [18].

Given these considerations, this paper develops a conceptual framework to examine the relationship between transformational and transactional leadership styles and business performance among Malaysian small business owners.

## **2. Literature Review**

Discussions on leadership by scholars and past researchers have focused more on traits, behaviours, influences, interaction patterns, relational roles, human orientation, and balance of tasks and goal achievement [19,20]. Bass [21] has expanded the discussion to include group processes, personality traits, encouragement of obedience, persuasion, goal achievement, and acceptance of structure. In conclusion, there are two main factors when discussing the concept of leadership and the leader [20]. First, at least two individuals must be involved because leadership is a group phenomenon. Second, it often involves a strong influence. Hence, Yukl [20] has defined leadership as the process of influencing members to understand and agree on what needs to be done and how to do it to achieve organisational objectives or goals, thereby improving business performance [16,19].

According to Nave [22], a firm's success or failure depends on the leadership style practised by an organisation [23]. Organisations need effective leaders who understand the complexities of global environmental change to continue competing and succeeding. Thomas [24] generally assumes that the leader of an organisation has a significant and likely impact on the organisation's performance because an effective leader will ensure the organisation achieves success [25].

Past studies have found that leadership styles are contingent upon the current environment, and not all leadership styles can be matched to every situation [26,25]. Differences in leadership style, whether transformational or transactional, may affect an organisation's effectiveness and performance [23]. Studies have shown that transformational leaders are more effective than transactional leaders. But transformational and transactional leadership styles cannot be seen from

opposing approaches to making them feasible [15,17]. This is because transformational leadership is developed based on transactional leadership [16].

Furthermore, Judge and Bono [27] state that transformational leadership can contribute to the impact of transactional leadership, while transactional leadership cannot replace the role of transformational leadership. However, leaders can use both styles in different situations, as suggested by contingency theory [28]. In this regard, this study examines the relationships among variables related to transformational and transactional leadership styles and the performance of small business firms in Malaysia. Specifically, the proposed conceptual relationships discussed in this paper are:

1. The relationship between each transformational leadership style variable (idealized influence, inspirational motivation, intellectual stimulation, and individual consideration) and the performance of small businesses in Malaysia.
2. The relationship between transactional leadership styles (contingent rewards, management-by-exception: active and passive) and the performance of small businesses in Malaysia.

### *2.1 Transformational Leadership Style with Small Business Performance*

Transformational leadership is a dynamic process in which leaders influence followers by altering their awareness of what is important, encouraging them to view challenges and opportunities from a new perspective. This leadership style is characterised by the leader's ability to inspire and motivate followers to transcend their self-interests for the greater good of the organisation or society [19]. Transformational leaders achieve this by being role models, fostering innovation, and aligning individual aspirations with organisational goals. They emphasise ethical standards and create a shared vision that motivates followers to exceed their usual performance levels. The following sections delve into the key aspects of transformational leadership [9,30]. There are four variables for a transformational leadership style, namely;

- i. Idealized influence (traits and behaviors) – Followers often admire, respect, and trust their leaders, which can lead them to emulate these leaders. Various factors, including the perceived authenticity, ethical standards, and charismatic qualities of the leader, influence this emulation. Followers are not passive recipients but active participants in the leadership process, and their willingness to emulate leaders is shaped by the trust and relationship they build with them. This dynamic is further influenced by leaders' leadership styles and values, which can inspire followers to adopt similar behaviors and attitudes [9,31].
- ii. Inspirational Motivation – Leaders play a crucial role in motivating followers to achieve set goals by encouraging them to envision a positive future. Transformational and charismatic leadership styles are particularly effective in this regard, as they focus on inspiring and motivating followers through a shared vision and emotional connection. Transformational leaders stimulate innovative work behaviors and provide inspirational motivation, which helps followers align their personal goals with the organization's vision [32]. Charismatic leaders, on the other hand, use envisioning, empathy, and empowerment to enhance followers' motivation and performance [33]. These leadership styles challenge followers to imagine a better future and work towards it, thereby fostering a sense of purpose and commitment.
- iii. Intellectual stimulation – leaders encourage followers to challenge existing assumptions and explore innovative solutions to problems. This leadership style fosters an environment where

creativity and critical thinking are prioritized, thereby enhancing problem-solving capabilities and organizational innovation. Transformational leaders achieve this by motivating followers to transcend their self-interests for the collective good, thereby promoting a culture of continuous improvement and learning [9].

- iv. Individual consideration emphasizes treating followers as unique individuals, addressing their specific needs, and fostering personal development. This approach is integral to transformational leadership, in which leaders act as mentors, providing tailored support and guidance to each follower's circumstances. Research indicates that leaders who exhibit individualized consideration positively influence organizational performance by enhancing motivation and morale among their teams [19,31].

Past studies have shown that the variables of transformational leadership styles (influence through superior performance, motivation through inspiration, intellectual stimulation, and individualised consideration) have a strong relationship with organisational effectiveness or performance [34,35]. Some studies have suggested that each component of the transformational leadership style can positively predict business performance [23]. A field study conducted by Howell and Avolio [36] found that transformational leaders have a significantly positive relationship with business performance in the financial industry. The results of their study showed that the influence of excellence, intellectual stimulation, and individual judgement was positively correlated with contingent rewards and performance. The study's findings align with those of a survey by Avolio *et al.* [37], which reported that transformational leadership has a significant positive relationship with financial performance across five performance indicators: market share, share price, return on assets (ROA), earnings per share (EPS), and debt-to-equity ratio.

The relationship between transformational leadership styles and business performance has been a subject of extensive research, with mixed findings. Hancott [38] found no significant relationship between CEO transformational leadership scores and organisational performance, except for the positive impact of inspiration, motivation, and intellectual stimulation on business performance. This aligns with studies by Waldman *et al.*, [39] and Tosi *et al.*, [40], which also reported insignificant relationships between transformational leadership and firm performance. However, other studies suggest a more nuanced understanding of this relationship, highlighting the potential positive impacts of transformational leadership on organisational outcomes.

Therefore, based on the theories and empirical studies presented, this study intends to test the following hypotheses:

- H1a: Idealised influence (traits and behaviour) has a significant positive relationship with small business performance.
- H1b: Inspirational motivation has a significant positive relationship with small business performance.
- H1c: Intellectual stimulation has a significant positive relationship with small business performance.
- H1d: Individual considerations have a significant positive relationship with small business performance.

## *2.2 Transactional Leadership Style with Small Business Performance*

Transactional leadership style refers to a leader who guides and motivates followers to reinforce goals by explaining roles and tasks [16]. Transactional leadership is based on the concept of exchange between leaders and their followers. Burns [41] found that transactional leadership occurs when an

individual takes the initiative to make a connection with another party to change something of value. There are three variables examined for transactional leadership style, namely;

- i. Contingent rewards – leaders offer rewards to subordinates in response to demonstrated performance [15]. The rewards offered may be in positive or negative form [42]. Therefore, followers will be motivated by the promised rewards or by the desire to avoid punishment [9].
- ii. Management by exception (active) – focusing on the explanation of goals and instructions for carrying out tasks [43]. The leader supervises each of his employees and rewards them according to the terms of the agreement. Employees who meet the set standards will be positively rewarded, while employees who do not achieve the targeted performance will be punished [44]. The leader will also use his influence when necessary to maintain control and improve his employees' performance.
- iii. Management by exception (passive) – Leaders will only intervene when there is a gap between the performance they want to achieve and the actual performance [9]. Leaders will pay attention to subordinates only when mistakes are made and need corrective action [36]. Therefore, leaders do not seek to monitor or influence firm performance [44]. This approach can lead to detrimental outcomes, as inaction may signal to employees that poor performance is acceptable, ultimately resulting in decreased motivation and productivity [45].

Contingency theory suggests that the effectiveness of leadership styles, such as transactional and transformational leadership, depends on situational factors. In specific contexts, transactional leadership is more effective than transformational leadership. This is particularly evident in environments characterised by stability and predictability, where clear rules and structured processes are essential for maintaining operational efficiency. Transactional leadership, with its focus on contingent rewards and management by exception, can be more suitable in such settings, as it aligns with the need for consistency and control [46]. This statement is supported by past studies that have reported a positive relationship between a transactional leadership style and firm performance [47,48]. DeClerk [47] found that retail firms' hourly sales productivity increased when leaders adopted transactional leadership styles towards their employees. Meanwhile, Yang [48], who conducted a study on SME entrepreneurs in Taiwan, found that the degree of a significant positive relationship between transactional leadership style and performance was smaller than that of transformational leadership style.

From the perspective of transaction leadership style variables, contingent rewards showed stronger positive relationships with performance [49]. Empirical and meta-analysis studies by Lowe *et al.* [50] have found that the leadership dimension of contingent rewards is positively correlated with effectiveness. Howell and Avolio [36] anticipated that contingent rewards would be positively related to business-unit performance. Studies have also found that contingent reward practices are positively associated with subordinate performance effectiveness [49], thereby indirectly improving the firm's performance.

Furthermore, the study's findings on the dimensions of management leadership through active and passive exclusion were mixed, ranging from positive to negative correlations [51]. Bass and Avolio [52] reported a positive correlation between management through active exclusion and organisational effectiveness. These findings are supported by a study by Howell and Hall-Merenda [53], which reported a strong positive relationship between management through active exclusion and follower performance when leaders are physically close to employees. These findings differ from

those of other studies, such as Avolio and Bass [37] and Tejeda *et al.* [54], which found a relationship between management through passive exclusion and low performance or insignificant changes. These findings are supported by Gardner and Stough [55] and Walumba *et al.* [56], who found that leaders who demonstrated a managerial leadership style through passive exclusion were ineffective [48]. Meanwhile, a study by Yang [48] found that management through passive exclusion was significantly negatively associated with business performance. Based on the above discussion, the researcher has made a hypothesis related to the relationship between each transaction leadership style variable and business performance, namely;

H2a: Contingent rewards have a significant positive relationship with small business performance.

H2b: Management by exception (active) has a significant positive relationship with small business performance.

H2c: Management by exception (passive) has a significant positive relationship with small business performance.

Despite extensive empirical research on leadership styles and business performance, findings remain inconsistent, particularly within the SME context. This inconsistency underscores the need for a stronger theoretical foundation to explain how and why leadership behaviours affect small business performance.

### **3. Underpinning Theoretical Framework**

This study is grounded in three complementary theoretical perspectives: transformational leadership theory, transactional leadership theory, and contingency theory. Together, these perspectives explain how and why specific leadership behaviours influence small business performance, thereby providing a clear theoretical foundation for the proposed hypotheses.

Transformational leadership theory emphasises leaders' ability to inspire followers to move beyond self-interest in pursuit of collective goals, fostering innovation, commitment, and a long-term orientation [9,15]. Within SMEs, which often face resource constraints and environmental uncertainty, such behaviours are particularly critical. Idealised influence and inspirational motivation enhance trust, a shared vision, and employee commitment, all of which are essential for sustained performance [20]. Intellectual stimulation promotes creativity and problem-solving, enabling SMEs to adapt to changing market conditions, while individualised consideration supports employee development and motivation. Accordingly, the dimensions of transformational leadership are theorised to be positively related to small business performance (H1a–H1d).

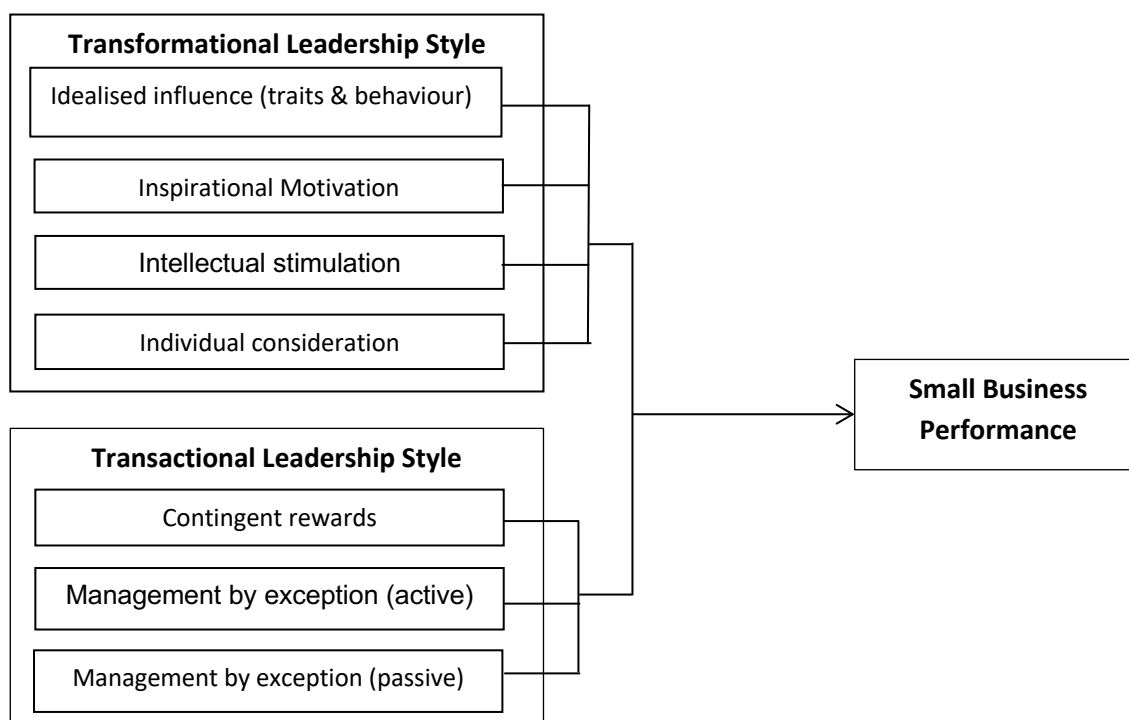
By contrast, transactional leadership theory is grounded in exchange-based relationships between leaders and followers, whereby performance is reinforced through contingent rewards and corrective actions [21,41]. In small business settings that require efficiency, task clarity, and operational control, transactional leadership behaviours can also enhance performance. Contingent rewards clarify performance expectations and reinforce goal attainment, while active management-by-exception enables leaders to monitor deviations and ensure performance standards are met [16]. However, passive management-by-exception, in which leaders intervene only after problems occur, may undermine performance due to delayed corrective action. These theoretical arguments underpin the proposed relationships between transactional leadership dimensions and small business performance (H2a–H2c).

Contingency theory integrates these perspectives by asserting that no single leadership style is universally optimal; rather, leadership effectiveness depends on contextual factors such as firm size,

industry characteristics, and environmental volatility [25,28]. Applying a contingency perspective helps explain the mixed findings reported in prior leadership–performance research and supports the view that transformational and transactional leadership operate as complementary mechanisms whose effectiveness varies across situations. Grounded in these theoretical foundations, the study’s conceptual framework links leadership dimensions directly to small business performance outcomes.

#### 4. Conceptual Framework

Based on the literature review and the hypotheses developed, the study's conceptual framework is illustrated in Figure 1.



**Fig. 1.** Conceptual framework

The model in this study presents the overall framework recommendations to be examined and analysed. Figure 1 illustrates the proposed relationship between leadership style dimensions (independent variable) and small business performance (dependent variable).

#### 5. Methods

Although this paper is conceptual, it outlines a proposed methodological approach to guide future empirical validation of the framework. Future studies may focus on small manufacturing (including agro-based) and manufacturing-related service firms operating in Malaysia and registered with SME Corp Malaysia. Probability-based sampling techniques, such as simple random sampling, may be employed to enhance representativeness and reduce sampling bias. This approach is essential for obtaining a representative sample and, in turn, improving the reliability of any future empirical findings.

Future empirical research may collect data via both online and face-to-face surveys to obtain responses from SME owners or owner-managers. Leadership styles may be measured using the

Multifactor Leadership Questionnaire (MLQ-5X), a widely recognised instrument developed by Avolio and Bass [9]. The MLQ-5X includes items that assess transformational and transactional leadership behaviours using a 5-point Likert scale. It evaluates multiple dimensions of leadership and has been used in prior research to explore associations between leadership behaviours, organisational effectiveness, and employee performance [57]. This instrument has been widely used to examine leadership behaviours and their associations with organisational outcomes in prior studies, making it suitable for future empirical research seeking to assess transformational and transactional leadership dimensions within the SME context [58].

Small business performance may be operationalised using objective financial indicators averaged over three years, consistent with prior studies such as Wiklund and Shepherd [59]. This approach reduces the effects of annual fluctuations and provides a more stable representation of firm performance.

To examine the proposed relationships, future empirical studies may use statistical techniques, such as correlation and multiple regression, to assess the strength and direction of associations between leadership styles and business performance. This proposed methodological outline demonstrates the empirical testability of the conceptual framework and offers guidance for future research.

## **6. Conclusions**

This paper develops a conceptual framework to examine the relationship between transformational and transactional leadership styles and small business performance in Malaysia. In response to inconsistent findings reported in prior empirical studies on leadership effectiveness [15,20], the framework integrates transformational and transactional leadership theories with contingency theory to explain how different leadership behaviours influence SME performance under varying organisational and environmental conditions [25,28]. Rather than treating leadership styles as mutually exclusive, the framework conceptualises transformational and transactional leadership as complementary approaches that may jointly enhance small business outcomes [9,17].

From a theoretical perspective, this study contributes by clarifying the mechanisms by which specific leadership dimensions are expected to influence SME performance and by situating these relationships within the Malaysian small-business context. Adopting a contingency-based perspective, the framework offers a plausible explanation for the mixed findings reported in prior leadership–performance research. It provides a structured foundation for future empirical testing of the proposed hypotheses [20].

Several limitations should be acknowledged. First, as a conceptual paper, this study does not include empirical data or statistical analysis. Second, the proposed framework focuses specifically on Malaysian SMEs, which may limit its generalisability to other national or institutional settings. Third, the framework does not explicitly incorporate potential mediating or moderating variables, such as organisational culture or environmental turbulence, which have been highlighted in prior leadership studies as influential contextual factors [28].

Despite these limitations, the study offers important practical implications. For entrepreneurs, the framework underscores the value of adopting flexible leadership approaches that align with organisational needs and environmental demands, rather than relying on a single dominant leadership style [15,20]. For policymakers and government agencies, the framework highlights the importance of designing SME leadership development programmes that balance the motivational capabilities of transformational leadership with the performance-management competencies of transactional leadership [16,41]. Finally, future research is encouraged to empirically examine the



proposed framework using longitudinal designs, multi-source data, and sector-specific analyses further to refine the understanding of leadership effectiveness in SMEs.

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