

# EFFECT OF TRANSFORMATIONAL AND TRANSACTIONAL ON SMES IN INDONESIA

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## EFFECT OF TRANSFORMATIONAL AND TRANSACTIONAL ON SMEs IN INDONESIA

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### Abstract

This study analyzed the direct and indirect effect of transformational and transactional leadership on SME performance. This was conducted in seven regencies/cities in East Java Province, with 165 SMEs on superior indigenous food and beverage. The results showed that transformational leadership has a positive and significant effect on the innovation and performance of SMEs directly and indirectly. Transactional leadership has a positive and insignificant effect on SMEs' innovation and performance directly. However, transactional leadership was found to have a positive and significant effect on SME performance indirectly. In conclusion, transformational leadership is more important for improving the performance of SMEs in Indonesia compared to transactional.

**Keywords:** transformational leadership, transactional leadership, innovation, performance, SMEs

**JEL Classification** L25, L26, M10

### INTRODUCTION

Small Medium Enterprises (SMEs) is one of the leading forces that drive economic development in Indonesia. According to data obtained from the Ministry of Cooperatives and SMEs, the 2017 contribution is as follows 1) 99.99% business units, 2) 97.02% of labor, 3) 60% of Gross Domestic Product (GDP), 4) 14.17% of non-oil exports, and 5) 58.18% of investments. These show that SMEs have great potential in mobilizing economic activities. Conversely, SMEs are constantly faced with competitive pressure due to globalization; therefore, there is a need for improved innovation and performance (Khaliq et al., 2014).

In addition, the widely developed leadership paradigm has attracted numerous practitioners and academics. Burns (1978) reported that leadership is distinguished into two types: transformational and transactional. Subsequently, several studies concerning their direct effects on SME innovation and

performance have been conducted. The results from previous studies show that numerous research gaps can be raised as a problem.

According to some studies, transformational leadership influences SME innovation (Md Saad & Mazzarol, 2010; Aslan et al., 2011; Iscan et al., 2014; Sang, 2017; Gashema & Gao, 2018; Ur Rehman et al., 2019). However, Feranita et al. (2017a) reported that it had no significant effect on SME innovation.

In addition to certain researches, it was also stated that it influences SME performance (Iscan et al., 2014; Ozer & Tinaztepe, 2014; Arham, 2014; Hee Song et al., 2016; Israel, 2016; Singh, 2016; Sheshi & Kercini, 2017; Arsawan et al., 2017; Sulistiyani et al., 2018; Boukamcha, 2019; Afriyie et al., 2019; Manzoor et al., 2019; Ur Rehman et al., 2019). These contradict the results from the study conducted by Feranita et al. (2017b), which stated that transformational leadership has no significant effect on SME performance.

Transactional leadership influences SME innovation (Md Saad & Mazzarol, 2010; Sang, 2017; Ur Rehman et al., 2019). However, Aslan et al. (2011) and Iscan et al. (2014) showed that it does not have a significant effect on SME innovation.

Several studies reported that transactional leadership influences SME performance (Singh, 2016; Mgeni & Nayak, 2016; Israel, 2016; Asiimwe et al., 2016; Arsawan et al., 2017; Ur Rehman et al., 2019). Iscan et al. (2014) and Ozer & Tinaztepe (2014) stated that there is no significant effect on SME performance.

Only a few studies have analyzed the indirect effect of both transformational and transactional leadership on SME performance with innovation as a mediator (Md Saad & Mazzarol, 2010; Ur Rehman et al., 2019). Although, empirical evidence shows that SME performance is also influenced by innovation (Donkor et al., 2018; Afriyie et al., 2019; Yasin et al., 2014; Lu et al., 2018; Ur Rehman et al., 2019; Nguyen et al., 2018; Vasconcelos & Oliveria, 2018; Restrepo-Morales et al., 2019).

Theory Resource-Based View (RBV) states that a company's strategic assets, such as an innovative organizational culture, affect its performance (Barney, 1991). Therefore, this study focuses on the direct and indirect influence of both

transformational and transactional leadership on SME performance with innovation as a mediating variable.

The selected SMEs were those situated in Probolinggo City, Probolinggo, Lumajang, Jember, Bondowoso, Situbondo, and Banyuwangi Regencies because they have exclusive indigenous food and beverage businesses. SMEs need to be able to utilize its potential properly while depicting good leadership to improve its innovation and performance.

This research consists of four sections. The first section reviews the literature and generates hypotheses concerning the effects of transformational and transactional leadership on SME innovation and performance. The second section examines the research methods applied, while the third presents the results from path analysis. The fourth section discusses the implications of the results with a conclusion.

## LITERATURE REVIEW AND THE DEVELOPMENT OF HYPOTHESES

### 1.1 Transformational Leadership, Innovation, and SME Performance

Transformational leadership drives innovation in two ways. Firstly, it is able to boost the motivation of the employees (intrinsic) by stimulating creativity, which is the primary key to innovation (Shin & Zhou, 2003). Secondly, it offers intellectual stimulation, thereby encouraging employees to think "outside the box" (Elkins & Keller, 2003).

Previous studies discovered the influence of transformational leadership on SME innovation. In Turkey and Malaysia, it has a significant influence on SME innovation (Iscan et al., 2014; Aslan et al., 2011; Md Saad & Mazzarol, 2010; Ur Rehman et al., 2019). Transformational leaders also play a huge role in advancing SME's innovation in East African countries, such as Kenya (Sang, 2017) and Rwanda (Gashema & Gao, 2018). Therefore, the following hypothesis was reported

H1: Transformational leadership influences SME innovation.

<sup>47</sup> According to Bass & Riggio (2006), these leaders motivate their employees to demonstrate an exceptional performance level, which exceeds expectations. This boosts employee satisfaction, as well as their commitment to the company.

Several empirical studies show that transformational leadership tends to improve SME's performance (Sheshi & Kercini, 2017; Boukamcha, 2019). In Turkey, the influence is stronger than other leadership styles (Iskan et al., 2014; Ozer & Tinaztepe, 2014).

In West African countries, transformational leadership improves SME's financial performance in Nigeria (Israel, 2016) and marketing performance in Ghana (Afriyie et al., 2019). Meanwhile, in some Asian countries such as India and Pakistan, <sup>5</sup> there is a significant relationship between transformational leadership and SME performance (Singh, 2016; Manzoor et al., 2019).

Subsequently, transformational leadership significantly influences <sup>46</sup> SME performance in Asian countries, such as Malaysia (Arham, 2014; Hee Song et al., 2016; Ur Rehman et al., 2019) and Indonesia (Arsawan et al., 2017; Sulistiyanani et al., 2018). Therefore the second hypothesis is as follows:

H2: Transformational leadership influences SME performance.

Dougherty & Hardy (1996) stated that this style of leadership facilitates unconventional and innovative ways of reasoning. In addition, it leads to work processes that are based on new knowledge and technology, which are fundamental to company performance.

In Malaysia, transformational leaders' emphasis on product innovation exhibits stronger performance (Md Saad & Mazzarol, 2010). Innovative culture serves as a <sup>16</sup> mediator between transformational leadership style and SME performance (Ur Rehman et al., 2019). In line with this, the third hypothesis is reported as follows:

<sup>32</sup> H3: Innovation mediates the effect of transformational leadership on SME performance.

## **1.2 Transactional Leadership, Innovation, and SME Performance**

According to previous studies conducted in Malaysia, transactional leadership plays a significant influence on company innovation. Transactional leaders can emphasize SME innovation, especially in process innovation (Md Saad & Mazzarol, 2010). Transactional leaders are able to developed an innovative SME culture (Ur Rehman et al., 2019). This type of leadership has a significant and positive effect on Kenya's SME innovation (Sang, 2017). It was therefore concluded that:

H4: Transactional leadership influences SME innovation.

<sup>15</sup> Transactional leadership is considered an important indicator to measure company performance. It focuses on the need to maintain the status quo to increase company revenue (Bass, 1985).

In some Asian countries such as India and Malaysia, it <sup>7</sup> has a significant influence on the performance of SMEs (Singh, 2016; Ur Rehman et al., 2019). According to a study conducted by Arsawan et al. (2017), Indonesia's leadership style is recommended for sustainable SMEs growth. Transactional leadership was also discovered to have a <sup>31</sup> positive and significant relationship with SME performance in African countries, such as in Tanzania (Mgeni & Nayak, 2016), Nigeria (Israel, 2016), and Kenya (Asiimwe et al., 2016). The following hypotheses are stated as follows:

H5: Transactional leadership influences SME performance.

It improves performance through the mediating role of innovation, which is one of the company's strategic assets (Barney, 1991). Ur Rehman et al. (2019) reported that in Malaysia, SMEs that implemented innovative culture were significantly able to mediate <sup>5</sup> between transactional leadership style and SME performance. Therefore, the sixth hypothesis was stated as follows:

H6: Innovation mediates the effect of <sup>5</sup> transactional leadership on SME performance.

### 1.3 Innovation and SME Performance

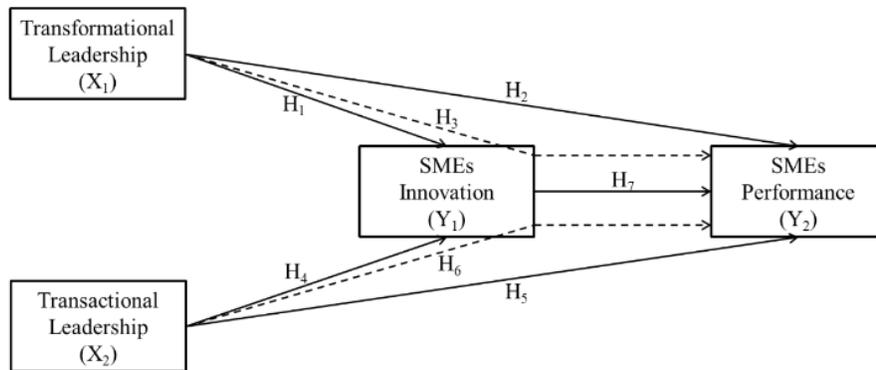
SMEs with strong innovative capabilities are at an advantage over their competitors because it tends to boost performance (Li & Mitchell, 2009; Rosenbusch et al., 2011).

Previous studies stated that one of the factors that influence SME performance is innovation (Donkor et al., 2018; Afriyie et al., 2019). Subsequently, a high level of innovative capacity tends to improve performance on a large scale.

It also has a significant influence on the performance of SMEs in Asian countries, namely Pakistan (Yasin et al., 2014), China (Lu et al., 2018), and Malaysia (Ur Rehman et al., 2019). In Vietnam, there is a positive causality relationship that changes from sales growth to SME innovation (Nguyen et al., 2018). Likewise, in America, such as Brazil (Vasconcelos & Oliveria, 2018) and Colombia (Restrepo-Morales et al., 2019). Therefore, the final hypothesis in this study is:

H7: Innovation influences SME performance.

Figure 1 shows the research framework and hypotheses based on theoretical and empirical studies.



Note:

—————▶ : direct effect  
 - - - - -▶ : indirect effect

**Figure 1.** Research Conceptual Structure

## RESEARCH METHOD

This research involves all the entire 280 foods and beverage SMEs in Probolinggo City, Probolinggo, Lumajang, Jember, Bondowoso, Situbondo, and Banyuwangi Regencies. This sector was chosen because it is one of the main focuses of the government in implementing the "Making of Indonesia 4.0" program. The seven regencies or cities were selected because they excelled more in this sector than in the eastern development corridors.

This research applied a proportionate sampling method to determine the relative size of each regency/city. The number of samples was detected using the Slovin formula with an error rate of 5%, and 165 SMEs were obtained. The unit of analysis is the leader, entrepreneur, owner, or manager of the SMEs. Data collection was obtained from questionnaires shared to the respondents from April to June 2019, with a 5-point Likert scale adapted from the appropriate literature.

According to Burns (1978), transformational leadership provides stimulation and inspiration for employees to achieve extraordinary results. On the contrary, transactional leadership offers financial rewards following the productivity generated by employees. The measurement of these variables was adapted from a study conducted by Aslan et al. (2011). Therefore, this research focuses on three dimensions of transformational leadership, namely charisma, intellectual stimulation, and individual consideration. It also focuses on two dimensions of transactional leadership, such as contingent reward and exception-passive management.

Innovation is the company's ability to adopt new ideas, products, and processes successfully. The measurement of these variables is adapted from a questionnaire developed by Ciang Wu (2017), which consists of three dimensions, namely product, process, and organizational innovation. Performance is defined as the company's achievement, and the variables were measured from the research conducted by Ar et al. (2011) and McDermott et al. (2012). Its dimensions are measured based on the market shares, sales, and profits of the competitors.

This study used path analysis to determine the direct and indirect effect of both transformational and transactional leadership on SME performance, with

innovation serving as its mediator, using the LISREL software for hypothesis testing.

## RESULTS

Based on the results from the instrument validity test conducted on the variables such as transformational and transactional leadership, innovation, and performance, a correlation value of p-value  $< \alpha$  (0.05) was obtained; therefore, all items are declared valid. In accordance with the results from the instrument reliability test, the Cronbach Alpha coefficient of  $> 0.60$  was determined; therefore, the variables were declared to be reliable. The results from the validity and reliability tests are shown in Table 1.

**Table 1.** The result of validity and reliability test

Variable and Dimension	Cronbach Alpha	Correlation
Transformational leadership	0.891	
Charisma		
• A leader respected by the employee.		0.715
• Employees are proud of their leader.		0.506
• The leader considers the results ethically.		0.674
Intellectual Stimulation		
• Leaders have a diverse point of view.		0.712
• The leader advises the employee.		0.751
• Leaders state their expectations.		0.728
Individual considerations		
• Leaders teach and train employees.		0.728
• Leaders' aid the employees		0.779
• Leaders offer feedback		0.851
Transactional leadership	0.791	
Contingent reward		
• Employees support the leader.		0.495
• The leader offers an appreciation.		0.644
• The leader appreciates good work.		0.785
Exception-passive Management		
• A leader executes an action after a bad situation.		0.624
• Unprepared leader unless under coercion.		0.718
• The leader intervenes when an issue becomes serious.		0.375
Innovation	0.846	

Variable and Dimension	Cronbach Alpha	Correlation
Product innovation		
• The company introduced or triggered new product innovations.		0.911
Process Innovation		
• The company introduced or triggered new process innovation.		0.877
Organizational Innovation		
• The company introduced or triggered new managerial innovation.		0.837
Performance	0.908	
Market Share		
• Compared to competitors, the company has a better market share.		0.911
Sales <sub>2</sub>		
• Compared to competitors, the company has a better sales.		0.950
Profit		
• Compared to competitors, the company has a better profit.		0.895

According to Table 2, several conclusions were drawn from the general description of the respondents based on gender, age, marital status, educational background, and duration of business. First, the majority of respondents were women (81.8%). Secondly, the majority were between the ages of 41-50 years (54.5%). Thirdly, almost all the respondents were married (96.4%). Fourthly, they are mostly dominated by senior high school (39.4%) and junior high schools (32.1%) graduates. Fifthly, the duration of the business is 6-10 years (44.8%).

**Table 2.** Respondent's general description

No	Characteristic	Description	Distribution	
			Frequency	Percentage (%)
1.	Gender	Male	30	18.2
		Female	135	81.8
		<b>Total</b>	<b>165</b>	<b>100.0</b>
2.	Age (year)	21-30	6	3.6
		31-40	35	21.2
		41-50	90	54.6
		> 50	34	20.6
		<b>Total</b>	<b>165</b>	<b>100.0</b>

No	Characteristic	Description	Distribution	
			Frequency	Percentage (%)
3.	Marital Status	Married	159	96.4
		Unmarried	1	0.6
		Widow/widower	5	3.0
		<b>Total</b>	<b>165</b>	<b>100.0</b>
4.	Latest Education	Junior High School	53	32.1
		Senior High School	65	39.4
		Diploma	2	1.2
		Bachelor (S1)	8	4.9
		Other	37	22.4
		<b>Total</b>	<b>165</b>	<b>100.0</b>
		5.	Leading Experience (years)	≤ 3
4-5	42			25.5
6-10	74			44.8
11-15	12			7.3
> 15	22			13.3
<b>Total</b>	<b>165</b>			<b>100.0</b>

According to the normality test results, the entire variables were normally distributed, which is shown by the p-value of skewness and kurtosis, which is determined as  $> 0.05$ . Likewise, multivariate normality shows the p-value of skewness and kurtosis to be  $0.750 > 0.05$ . This indicates that the data is normally distributed.

The results from the direct influence test are shown in Table 3. The entire model consists of 5 direct paths, 3 of them have a significant effect, while the remaining 2 have a non-significant effect. Therefore, hypotheses 1, 2, and 7 are accepted, while 4 and 5 were rejected.

**Table 3.** Hypothesis testing results from the direct effect

Hypotheses	Regression Model	Estimation Value	t-value
H <sub>1</sub>	Transformational leadership (X <sub>1</sub> ) → SME innovation (Y <sub>1</sub> )	0,35	3,77*
H <sub>2</sub>	Transformational leadership (X <sub>1</sub> ) →	0,16	1,72**

	SME performance (Y <sub>2</sub> )		
H <sub>4</sub>	Transactional leadership (X <sub>2</sub> ) → SME innovation (Y <sub>1</sub> )	0,13	1,43
H <sub>5</sub>	Transactional leadership (X <sub>2</sub> ) → SME performance (Y <sub>2</sub> )	0,06	0,66
H <sub>7</sub>	SME innovation (Y <sub>1</sub> ) → SME performance (Y <sub>2</sub> )	0,36	4,75*

Note: \* and \*\* means significant at levels 5% and 10%, respectively. The

Results from testing the indirect effect are shown in Table 4. Generally, the two indirect path models have a significant effect; therefore, hypotheses 3 and 6 are accepted.

**Table 4.** Hypothesis testing results from indirect effects

Hypotheses	Regression Model	Estimation Value	t-value
H <sub>3</sub>	Transformational leadership (X <sub>1</sub> ) → SME innovation (Y <sub>1</sub> ) → SME performance (Y <sub>2</sub> )	0,13	4,00*
H <sub>6</sub>	Transactional leadership (X <sub>1</sub> ) → SME innovation (Y <sub>1</sub> ) → SME performance (Y <sub>2</sub> )	0,05	1,95**

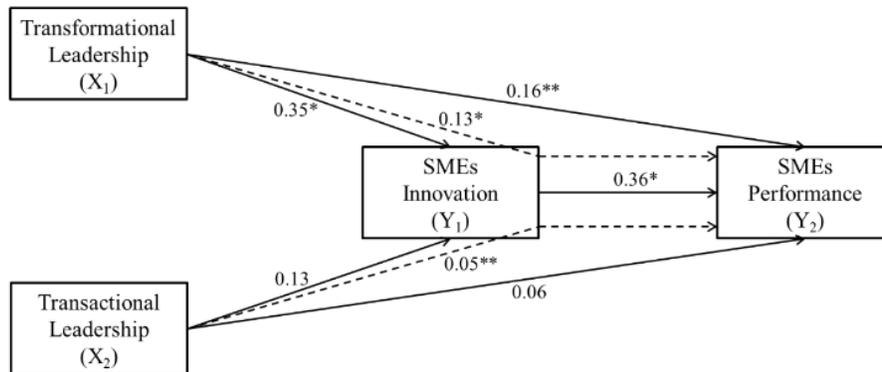
Note: \* and \*\* shows significance at levels 5% and 10%, respectively.

Table 5 shows the test results from the direct, indirect, and total effect. The total effect of each independent variable is stated as follows, 29% of transformational and 11% of transactional leadership.

**Table 5.** Test results from direct effect, indirect effect, and total effect

Regression Model	Direct Effect	Indirect Effect	Total Effect
Transformational leadership (X <sub>1</sub> ) → SME performance (Y <sub>2</sub> )	0.16	0.13	0.29
Transactional leadership (X <sub>2</sub> ) → SME performance (Y <sub>2</sub> )	0.06	0.05	0.11

Figure 2 shows concise results from path analysis.



Note: \* and \*\* shows significance at levels 5% and 10% levels, respectively.

**Figure 2.** The path coefficient of direct and indirect effects

## DISCUSSION

According to Table 3, the results from data analysis shows the t-value of 3.77, which is above the critical ratio (1.96); therefore, H<sub>1</sub> is accepted at the level of  $\alpha = 5\%$ . It was discovered that transformational leadership has a positive and significant effect on SME innovation. This means that transformational leadership boosts SME innovation.

In accordance with the responses of the respondents, its variables show 2 indicators in the very good category, while the remaining 7 are in a good category. This research shows that qualities of SME leaders such as charisma, intellectual stimulation, and individual consideration trigger innovation.

This finding supports the results from previous studies (Md Saad & Mazzarol, 2010; Aslan et al., 2011; Iscan et al., 2014; Sang, 2017; Gashema & Gao, 2018; Ur Rehman et al., 2019). Also, the evidence is provided, which shows that SME innovation is achieved through transformational leadership.

The analysis of the data in Table 3 shows that the t-value is 1.72, which is above the critical ratio (1.645); therefore, H<sub>2</sub> is accepted at the level of  $\alpha = 10\%$ . Therefore, transformational leadership has a positive and significant effect on SME performance. This means that this type of leadership boosts SME performance.

Furthermore, the majority of the SME leaders who filled out the research questionnaire were women (81.8%). Lopez-Zafra et al. (2012) reported that transformational leadership is determined by femininity; in other words, women tend to be more transformative. Subsequently, this is the desired leadership style because it has a positive influence on various performance outcomes (Chen et al., 2018).

This finding strengthens the results from previous studies (Iskan et al., 2014; Ozer & Tinaztepe, 2014; Arham, 2014; Hee Song et al., 2016; Israel, 2016; Singh, 2016; Sheshi & Kercini, 2017; Arsawan et al., 2017; Sulistiyani et al., 2018; Boukamcha, 2019; Afriyie et al., 2019; Manzoor et al., 2019; Ur Rehman et al., 2019). Conversely, this study is consistent with the study conducted by Bass and Riggio (2006), which stated that transformational leaders are able to incite their employees to achieve better performances.

Table 4 shows that the results from data analysis show that the t-value is 4.00, which is above the critical ratio (1.96); therefore,  $H_3$  is accepted at the level of  $\alpha$  5%. Transformational leadership has a positive and significant effect on SME performance in accordance with an innovative medium. This supports the findings from 2 previous studies (Md Saad & Mazarol, 2010; Ur Rehman et al., 2019). From the data shown in Table 5, the total effect of transformational leadership on SME performance offers a greater value than the total and direct effects of 0.29 and 0.16, respectively. Therefore it provides a greater contribution than the effect. Contributions made by innovation serves as a mediator between transformational leadership and the performances of SMEs.

This study also discovered that transformational leadership has a positive and significant effect on SME's innovation, as well as performance, both directly and indirectly. Therefore it was concluded that innovation mediators trigger an influence on SME performance.

In accordance with the data analysis in Table 3, the t-value is 1.43, which is below the critical ratios of 1.96 and 1.645; therefore,  $H_4$  is rejected at  $\alpha = 5\%$  and  $10\%$ . Transactional leadership has a positive and insignificant effect on SME

innovation. This shows that this leadership style has not been able to improve SME innovation.

This is in line with the studies carried out by Aslan et al. (2011) and Iscan et al. (2014). Previous researches were able to show the effect of transactional leadership on SME innovation by utilizing items in the manufacturing and service sectors (Sang, 2017; Ur Rehman et al., 2019). However, this study is based on SMEs in the manufacturing sector, particularly food and beverages. Although different outcomes are expected, assuming the research is conducted on SMEs in the manufacturing and service sectors.

In accordance with Table 3, the t-value is 0.66, and it is below the critical ratio, which is 1.96 and 1.645; therefore,  $H_5$  is rejected at  $\alpha = 5\%$  and  $10\%$ . This shows that transactional leadership has a positive and insignificant effect on the performance of SMEs. This means that the supporting indicators of this type of leadership have not effectively driven the performance of SMEs.

From an empirical perspective, the results from this research contradict previous studies (Sang, 2017; Ur Rehman et al., 2019). Ur Rehman et al. (2019) stated that there are 4 indicators: contingent rewards, exception-active management, exception-passive management, and passive management. Consequently, only 2 of the indicators contingent reward and exception-passive management were used in this research. However, this study is in accordance with Iscan et al. (2014) and Ozer & Tinaztepe (2014).

Table 4 shows the results from the data analysis where the t-value is 1.95, which is above the critical ratio of 1.645; therefore,  $H_6$  is accepted at  $\alpha = 10\%$ . Transactional leadership has a positive and significant effect on the performance of SMEs based on innovative mediators. These findings support the results from previous research (Ur Rehman et al., 2019). Table 5 shows that the total effect of transactional leadership on the performance of SMEs offers a greater value than its direct influence (total and direct effects are 0.11 and 0.06 respectively). Therefore, its contribution is more important than direct effect and serves as a mediator between transactional leadership and the performances of SMEs.

The findings from this study show that it directly has a positive and insignificant effect on the performance of SMEs. However, it indirectly has a positive and significant effect on SME performance (through innovation variables). Therefore, the influence of transactional leadership on the performance of SMEs is triggered by innovation mediators.

Based on the results from the data analysis in Table 3, the t-value is 4.75, which is above the critical ratio 1.96; therefore,  $H_7$  is accepted at the level of  $\alpha = 5\%$ . Innovation has a positive and significant effect on the performance of SMEs. This means that it boosts SME performance

The respondents' responses show that the innovative variable has two indicators stated in the good enough category and 1 in the good category. In addition, all the performance variables are in a good category.

These findings provide evidence that shows that indicators such as product, process, and organizational innovation have a significant influence on SME performance measured by market shares, sales, and profits. Empirically, these data are in accordance with previous studies that examined its effect on SME performance using different indicators of measurements (Donkor et al., 2018; Afriyie et al., 2019; Yasin et al., 2014; Lu et al., 2018; Ur Rehman et al., 2019; Nguyen et al., 2018; Vasconcelos & Oliveria, 2018; Restrepo-Morales et al., 2019).

## CONCLUSION

This research examined and analyzed the direct and indirect effect of both transformational and transactional leadership on SME's performance through innovative mediators. The results from the path analysis revealed that transformational leadership has a positive and significant effect on SME innovation and performance.

However, transactional leadership directly has a positive and insignificant effect on SME performance. Subsequently, it has an indirect positive and significant effect on SME performance through innovative mediators. This means that

innovation plays an important role in the relationship between transactional leadership and SME performance.

Additionally, transformational leadership has a greater total effect (29%) than transactional leadership (11%). Therefore this type of leadership plays an important role in improving the performance of SMEs in Indonesia.

In conclusion, two limitations were determined in this study. First, the samples taken are only from the manufacturing sector, specifically the food and beverage industries. Second, the study was conducted in only seven regencies or cities located in East Java Province. Therefore, further research on the manufacturing and service sectors that covers a wider area at the national level needs to be conducted to generalize the results.

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