How entrepreneurs create wealth in transition economies

Mike W. Peng

Executive Overview

Entrepreneurship has been flourishing in the transition economies of Central and Eastern Europe, the newly independent states of the former Soviet Union, and East Asia. Entrepreneurs in these countries are characterized by their sheer energy, relentless strategies, and sometimes controversial practices. How can entrepreneurs rise to create wealth in environments traditionally hostile to entrepreneurial activities? What can be learned from such an experience? Focusing on these two key questions, this article draws on research from a broad range of transition economies to identify three major entrepreneurial strategies of prospecting, networking, and boundary blurring. It also delineates important lessons for entrepreneurs active in transition economies and foreign entrants interested in these emerging markets.

The rise of entrepreneurship throughout the transition economies of Central and Eastern Europe (CEE), the newly independent states (NIS) of the former Soviet Union, and East Asia has fundamentally transformed these economies, and caught worldwide attention. Entrepreneurs and the start-ups they found create wealth and push these economies to a higher level of competitiveness through their sheer energy, relentless strategies, and sometimes controversial practices. Although there are numerous country- and region-specific studies, there have been few attempts that shed light on the overall development of entrepreneurship in transition economies from Shanghai to St. Petersburg. While there are many cultural, political, and economic differences permeating these countries, recent publications such as those by the World Bank and OECD have grouped them under the collective label of “transition economies.”

Increased knowledge about the wealth-creation process throughout transition economies can greatly enrich global entrepreneurship practice and research.

The Rise of Entrepreneurship

Entrepreneurship during the socialist era

Entrepreneurs are the founders of new businesses. Despite harsh political conditions, entrepreneurship existed in virtually all of these countries before major transitions took place in the 1980s. Before the transition, the private sector, which had a number of peculiar labels, such as the “gray,” “second,” and “underground” economy, was usually small, labor-intensive, and often informal. By the 1980s, most socialist governments started to loosen restrictions on the private sector, resulting in an initial wave of entrepreneurship. At that time, however, these countries were reluctant to legalize private property. The government still imposed a limit on the size of a private firm, such as seven employees in Hungary and eight in China (which was later lifted in the 1990s). What is remarkable is the rapid rise of entrepreneurship in such an ambiguous environment, with little protection of private property. Wherever and whenever the government had relatively few restrictions on the private sector, pockets of entrepreneurship, such as those in South China, would start to develop.

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A golden era during the transition

After a period of slow but steady growth in the 1980s, private entrepreneurship blossomed in the
1990s. The most fundamental driving force was the removal of the yoke of communism throughout CEE and the NIS. The other underlying force was the continued deterioration of the state sector. We may regard the lure of capitalism as a pull factor, and the failure of state-owned enterprises (SOEs) as a push factor. A combination of the pull and push factors resulted in the abolition of many restrictions on private firms. In turn, these transitions opened the floodgates of entrepreneurship, which rose to undermine the foundation of the socialist economy.

Since the mid-1990s, the majority of the GDP has been contributed by the private sector throughout CEE and the NIS (e.g., approximately 80 percent in Hungary, 75 percent in the Czech Republic, and 70 percent in Russia). At the same time, the nonstate sector in China has quietly but steadily become the backbone of the economy, contributing approximately 70 percent of total industrial output. The growth of the private sector has created jobs and at least partially compensated for the decline of SOEs. During the 1990s in CEE, about five percent of the adult working population attempted to start new firms or become self-employed, a figure very similar to the percentage of nascent entrepreneurs in the United States and Western Europe. The 1990s was indeed a golden era for entrepreneurial start-ups throughout transition economies.

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**Who Are These Entrepreneurs?**

What drives people to become entrepreneurs has remained an intriguing puzzle around the world, and perhaps more so in transition economies. Four types of entrepreneurs have emerged: farmers, gray individuals, former cadres, and professionals.

**Farmers**

Although private farming was eradicated in most socialist countries, Poland never nationalized its agriculture, and its private farmers owned more than 70 percent of the land in 1987. Even in countries where private farming had not been allowed before, the loosening of government regulations spurred a great deal of private farming. However, most private farmers would not bother to register their undertaking as a company. Over time, some of them organized along more formal lines, and attempted to grow beyond the family holdings. While most of them remain small, some of the better-managed ones have become larger and more visible. For example, the largest private company in China during the 1990s, the Hope Group, could trace its roots to private farming.

**Gray individuals**

Because there were very few possibilities under state socialism to lawfully organize entrepreneurial ventures, unlawful ways emerged in a gray economy. The socialist era left a legacy of disregard of the supremacy of the law. Too few formal laws governed economic behavior, and there was little legitimacy for the laws that did exist, which were routinely ignored. Thus, despite its lack of legality, the gray economy was widely tolerated and accepted by the public.

During the transition, frontier-style overnight accumulation of wealth through gray activities became possible. Ranging from small-scale tax evasion and bribery to large-scale mafia practices, all of these activities may be in violation of some laws or regulations. Since the emerging legal and regulatory frameworks are underdeveloped, their enforcement leaves numerous loopholes. As a result, these gray entrepreneurs emerge to take advantage of loopholes as intermediaries connecting individuals and organizations with economic exchanges that otherwise would not have taken place.

While strictly speaking violating laws and regulations, these individuals do not necessarily belong to criminal organizations, although some of them certainly do. Most of these people are entrepreneurs in a classical sense: “persons who add value by brokering the connection between others.” They blur the boundaries separating different sectors by taking advantage of the information and resource asymmetry across different sectors. In turn, they profit from these arbitrage opportunities. For example, they can trade foreign exchange through black markets, obtain business licenses from officials, and enforce contracts through security services. Some of these services are clearly of a criminal nature, such as resolving contractual disputes through assassination by the Azerbaijjan mafia active in Russia, resulting literally in cut-throat competition in some cases. The size of the overall gray economy is, of course, very difficult to estimate. Tentative figures in the mid-1990s (Table 1) put the total size of the unofficial gray economy at approximately 11–12 percent of
the GDP in the Czech Republic and Poland, about 30 percent in Bulgaria and Hungary, 40–50 percent in Russia and Ukraine, and, in the extreme case, over 60 percent in Azerbaijan and Georgia.14

Cadres

Cadres, former communist party leaders and officers, are widely believed to benefit from the transition by becoming entrepreneurs. People with more education are found, in general, to do better in market economies than those with less education.15 Cadres, who as a group are better educated than the general population, are thus likely to be in an advantageous position during the transition. Power accumulated under state socialism can be converted into assets of high value in a transition economy. During privatization, for example, strategically located cadres can take advantage of their positions in acquiring state property, as in the spontaneous privatization throughout CEE and the NIS. Cadres can also tap into their personal networks to acquire valuable resources from their former colleagues still in the government, maneuvering across different sectors as intermediaries who seek rents for their services.

In one case, a former Chinese cadre, who quit his post at the State Planning Commission in 1989, operated a $120 million company by 1995. The firm comprised a futures-and-commodities trading operation, a clinic to treat nearsightedness with lasers, and a collection of high-tech startups. One of the key reasons the former cadre did so well was that he had access to powerful friends and contacts in many government agencies. In another case, during the first period of major transitions in Hungary (1989–91), cadre-entrepreneurs more than doubled their personal income, while noncadre-entrepreneurs and the entire population increased their income by 73 percent and 59 percent, respectively.17

Professionals

Professional-entrepreneurs are entrepreneurs who previously held professional positions not directly related to the party state, such as lawyers, managers, engineers, and professors. In transition economies, they enhance the technology and professionalism of private firms, which traditionally concentrate on low-tech, labor-intensive sectors such as farming, restaurants, and retail shops. Professionals also increase the legitimacy of private firms. Less educated farmers and gray individuals with dubious backgrounds and activities do not inspire much confidence among the public. Cadre-entrepreneurs are widely viewed with suspicion

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and resentment by the public. Professionals, on the other hand, are better educated and have few connections with the party state or the gray economy. The added legitimacy of professionally run private firms, in turn, is likely to attract more experienced professionals and recent college graduates, thus fueling the development of these firms.

A group of defense scientists in 1991 started Vimpelcom, a high-tech startup that later became Russia's largest cellular-telecom provider and the first Russian company to earn a full listing on the New York Stock Exchange. Combining defense industry know-how, contacts in the telecom industry, and the lack of Soviet-era baggage that typically plagued many privatized firms, Vimpelcom was built from the ground up with Western-style management and accounting principles that made it easy to present the three years of U.S. standard audits required to list in New York.18

On the other hand, the development of products and services with more technology content requires more long-term investment, such as R&D. Unfortunately, the general environment in transition economies, characterized by policy instability and regulatory chaos, is not conducive to such investment.19 Moreover, professional-entrepreneurs' lack of connections with other sectors may be a liability rather than an asset. In an environment where personal ties figure prominently, entrepreneurs without deep and strong network relations may have a lot of difficulties in getting things done.

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In sum, economic transitions have provided powerful incentives for all sorts of entrepreneurs to mushroom. They tend to specialize in different fields, taking advantage of their particular strengths. Farmer-entrepreneurs usually focus on food and vegetable production, farm produce distribution, and low-tech manufacturing. Gray individuals are likely to specialize in various intermediary services, both legal and illegal. Cadre-entrepreneurs are known for their interest in relationship-intensive industries, such as trading, entertainment, and property development. Professionals-turned-entrepreneurs tend to be more interested in such knowledge- and technology-based ventures as computer software and architecture design.

**Major Entrepreneurial Strategies**

Recent research focusing on transition economies has highlighted three major entrepreneurial strategies: prospecting, networking, and boundary blurring.20 While they are not the only viable strategies in transition economies, individually or in combination, they do appear to be associated with the most successful entrepreneurs in these countries. These strategies are not necessarily unique to transition economies; prospecting and networking, for example, have been widely practiced by entrepreneurs elsewhere. What is interesting in transition economies is the importance of these strategies, whereby alternatives (e.g., acquisitions) are few. On the other hand, blurring the boundaries of public and private sectors in multiple directions does appear to be a unique challenge to global entrepreneurship practice and research. Therefore, our discussion below starts with a most generic strategy, and moves progressively to highlight more unusual strategies.

**Prospecting**

Prospectors are firms with a changing market, a focus on innovation and change, and a flexible organizational structure headed by younger, more aggressive managers, all of which are characteristic of entrepreneurial firms in transition economies.21 In contrast, defenders are firms with a narrow market, a stable customer group, and an established organizational structure managed by older, more conservative executives. Compared with larger SOEs and recently privatized ex-SOEs, which tend to be defenders, private firms are usually smaller and have a higher level of market orientation, agility, and flexibility. Often headed by younger individuals, startups also tend to adopt a simple organizational structure, which allows them to react quickly to opportunities. Startups also have little inherited organizational baggage from the socialist era, low fixed costs, and the ability to attract the most talented people.

Another way to view this strategy is to treat these startups as underdogs that have very little choice but to adopt guerrilla warfare tactics. Underdog firms cannot compete against the larger and more established rivals head-on. Instead, smaller firms conserve scarce resources for crucial battles. They use speed and stealth to create dis-
ruption by preempting competitors, and to be the first movers while forcing their competitors to be defenders or reactors. Such a quick movement often gives entrepreneurial startups substantial first-mover advantages by allowing them to build up a market share and increase brand-name awareness in new niche markets.

Poland’s Optimus Computer exemplifies such a strategy. Founded in 1988, this startup held 35 percent of the Polish PC market by 1995. The owner attributed his success to a guerrilla strategy that sought first-mover advantages when the PC revolution was starting to gain momentum in that country in the early 1990s. Optimus thrived by always moving ahead of the competitors in terms of products and services. Specifically, while competitors imported models approaching the end of their product life cycle, Optimus provided locally assembled, low-cost PCs equipped with the latest versions of Intel chips, Samsung monitors, and Microsoft operating systems.

This prospector or guerrilla strategy has several limitations. The industries that entrepreneurs enter tend to have relatively low entry barriers and less capital intensity. As a result, they often focus on labor-intensive farming, light manufacturing, and small-scale services, and shy away from large-scale, technology- and capital-intensive industries. (Optimus Computer is an exception.) While their larger rivals find it difficult to compete on speed and stealth, successful startups often attract a large number of other private firms to follow the first movers. Because of the nature of these industries (e.g., their low entry barriers), the first movers are often unable to defend themselves and, consequently, fail to sustain a competitive advantage. Therefore, entrepreneurial firms have a tendency to be footloose, exiting existing industries or niches and searching for new opportunities elsewhere. Finally, while the prospector or guerrilla strategy may be viable during the initial phase of the transitions, when there are a large number of unfilled niches, it is questionable whether this strategy can be pursued in the long run, when the economy becomes more developed and mature.

**Networking**

To some extent, entrepreneurial firms around the world rely on networking as a strategy. In transition economies, virtually every firm needs to pay attention to its networks, which are necessitated by the institutional environment.

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The lack of certain market-supporting institutions often leads managers and entrepreneurs to develop networks to perform basic functions, such as obtaining market information, interpreting regulations, and enforcing contracts. In an environment in which formal institutional constraints such as laws and regulations are weak, informal institutional constraints, such as those embodied in interpersonal networks, connections, and ties cultivated by managers and entrepreneurs (e.g., blat [connections] in Russia and guanxi [relationships] in China), help to at least partially overcome the infrastructure deficiencies by facilitating economic exchanges among members.

Compared with other firms such as SOEs, privatized firms, and foreign entrants, a networking strategy is perhaps more important for private startups. What is noteworthy about entrepreneurial networking is its urgency, intensity, and impact. Private firms initially suffer from a lack of legitimacy as new organizations because of their liability of age, which prompts stronger urgency for them to rapidly establish network ties with the environment. Specifically, they have to cultivate two sets of networks. The first is with entrepreneurs and managers at other firms, such as suppliers, buyers, and competitors, which may be useful in most economies. A second set of networks, with government officials, may be more unique to transition economies, because harassment from various government officials remains a constant danger. In Russia, for example, every private company must provide 28 quarterly reports to the tax authorities. In China, most private firms have to pay nearly 50 kinds of different taxes. Taxation and regulatory policies are often contradictory, and even the most scrupulous entrepreneurs cannot be in consistent compliance. It is not surprising that entrepreneurs clearly understand the importance of having good relationships with government officials, especially those in tax bureaus. In China, for example, the impact of network linkages with officials on firm performance is more important than those with entrepreneurs at other firms.

A second characteristic that distinguishes entrepreneurial networking is its intensity. In order to ensure survival, smaller firms often have to intensify their networking activities with larger, more
legitimate, and more powerful players. Moreover, a large number of them are in service industries, which, in general, are more relationship-intensive than manufacturing industries. Legal frameworks in transition economies are less developed in the service sector than in manufacturing, necessitating intense networking efforts.

Because of the small size of these startups, the contributions of individual entrepreneurs' personal networks tend to have a stronger impact on firm performance. In comparison, the impact of similar networks cultivated by managers at larger firms may be less pronounced because of these firms' sheer size. Moreover, being private owners, entrepreneurs can directly pocket the residual income if their firms perform well, thereby providing powerful incentives for them to network through entertainment, gift giving, and/or bribery.

A case in point are the struggles of the entrepreneurs heading China's Lucky Transportation, a trucking company servicing the construction industry. Several state-owned construction and trucking firms formed an informal enterprise group aiming at internal collaboration and excluding nonmembers. In order to grow, Lucky Transportation had to become a member of the group by cultivating personal ties between its entrepreneurs and other managers in the group, as well as with government officials. The entrepreneurs worked hard to be their friends, taking them out to dinner, and occasionally giving them such gifts as red envelopes, known to contain cash. Eventually, Lucky Transportation was accepted as a member of the group, enabling it to achieve significant growth—over 500-percent growth in sales during its first three years, 1992–95.

On the other hand, it is important to note the limitations of a networking strategy. One common and erroneous belief is to exaggerate the importance of personal networks. Possessing effective personal networks may be necessary but not sufficient for good performance.

Boundary blurring

Closely associated with networking, two specific types of boundary blurring exist, involving the blurring of boundaries separating public and private sectors, and of those separating legal and illegal sectors.

Blurring public-private boundaries

A surprisingly large number of entrepreneurial startups are not privately owned companies in a classical sense. Called collective enterprises, these nonstate, nonprivate startups are especially visible in the Chinese economy, and since the early 1990s have become the largest contributor to the GDP, over and above the purely private sector and the SOE sector. Collective enterprises, specifically, are non-SOEs subordinate to local governments and owned and operated collectively. Local governments benefit from these firms, which not only generate jobs, but also provide income streams and tax revenues over which local governments can have discretion. In contrast to CEE, outright privatization of these firms had not occurred in China until the late 1990s. However, hidden or informal privatization has been widespread. Specifically, entrepreneurs can bid for long-term leases to control these firms. Although such lease agreements do not entitle lease-holders to formal property rights, these agreements are widely viewed by the entrepreneurial lease-holders, as well as by the employees and the public, as de facto property rights. These public-private hybrid firms, therefore, represent a gradual evolution from public to private ownership. On the other hand, a large number of pure, private startups move in the opposite direction by choosing to register themselves as collective firms in an effort to appear to have some public ownership, or "wear a red cap." Given the residual antagonism against private entrepreneurs, many entrepreneurs are concerned about renewed hostility directed against them and the possible appropriation of their assets. Lucky Transportation is such a collective company that is a private firm in disguise.

In an environment still institutionally unfriendly to private ownership, it makes good sense for many entrepreneurs not to advertise the private nature of their firms. Even when discriminatory policies are removed, purely private firms are still at a great disadvantage in obtaining state-controlled resources such as bank credit. For example, frustrated by its inability to access credit, Carpenter Tan, a highly successful private startup in China, had to use advertisements in national media to plead to the banks, all of which were
state-owned. The campaign stirred up a nationwide debate on why it was so hard for private firms to raise capital. This contrasts sharply with the situation in developed economies, where banks advertise to promote their loans. Paradoxically, while refusing to support Carpenter Tan, the banks continued to supply capital to numerous money-losing SOEs that hardly paid interest, let alone principal. Although there was no discriminatory policy banning loans to private firms, bankers practiced self-imposed and unfair sanctions against private firms. While it was normal for banks not to recover anything from loans to SOEs, any loan loss associated with private firms would automatically lead to suspicions that the loan officer was guilty of embezzlement and collusion with entrepreneurs. “So why do I want to take any risk to provide loans to private firms?” one loan officer asked.30

Unfortunately, the experience of Carpenter Tan is not alone. Table 2 reveals a striking pattern of under-funding for non-SOE in China: while their 1996 share in total industrial output and value-added rose to 71.5 percent and 91.2 percent, respectively, their share of total bank loans remained below 16 percent.31 Non-SOE firms needed bank loans, but in most cases, their loan applications were simply denied, while banks continued to channel precious financial resources to SOEs. Nevertheless, because of the clout of local governments, changing to a collective status may allow private firms to gain better access to critical resources such as loans.

While some collective firms embody the evolution away from public ownership, other collective enterprises represent a movement away from private ownership. Given the general movement toward clearer specification of property rights throughout transition economies and the ambiguous property rights surrounding these firms, the question becomes: can ambiguous property rights sometimes be efficient? The answer is a qualified yes.32 Under the particular circumstances of the transition, such a collective hybrid strategy may lead to the best of the two worlds. On paper at least, these firms still retain public ownership, and many local governments take these firms under their wings by shielding them from harassment from other intrusive government agencies and helping them obtain needed resources. At the same time, through creeping privatization, most of these firms behave more like pure, private firms. In short, the public-private hybrid represents an interesting and previously unencountered phenomenon in global entrepreneurship practice and research, and deserves further attention from practitioners, researchers, and policymakers.

**Blurring legal-illegal boundaries**

In some CEE and NIS countries, the blurring of the legal-illegal boundaries has reached epic proportions. Russia seems to stand out as the most corrupt major economy in the world. While the true extent of the gray and/or illegal economy in Russia is difficult to assess, one estimate says approximately 70 to 80 percent of private companies may be paying extortion money to organized, mafia-type criminal gangs.33 Rising organized crime has occurred in just about every transition economy. Taking advantage of the entrepreneurial boom, many criminal organizations operate under the title of fully legal business firms with impeccable offices, letterheads, and bank accounts. Consider Multigroup, a small startup founded in Bulgaria in 1989. By 1996, it became a giant, with 8,000 employees, $1.5 billion in annual sales, and offices in a dozen countries from Russia to the Philippines. Despite its success, public opinion in Bulgaria widely suspects Multigroup of being an efficient scheme of siphoning off

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**Taking advantage of the entrepreneurial boom, many criminal organizations operate under the title of fully legal business firms with impeccable offices, letterheads, and bank accounts.**
public money from the communist era and laundering it to the benefit of ex-communist officials.\textsuperscript{34} To acknowledge the blurring of legal-illegal boundaries does not mean to celebrate it. However undesirable, the emergence of these gray organizations may be a natural by-product of economic transitions. In the absence of a strong formal legal and regulatory regime, informal constraints such as rules and regulations imposed by the mafia rise to fill the vacuum as a form of self-government to provide some public goods, such as protection from thieves and contract enforcement. In many cases, the mafia seems to have more effective contract enforcement mechanisms—the collection of payments and the delivery of punishment such as the cut-throat method discussed earlier—than the weak court and regulatory systems. To the extent that criminal organizations are able to provide better enforcement services than the predatory government, then there will continue to be a demand for such services.\textsuperscript{35}

While such a boundary-blurring strategy may be viable during the initial, chaotic phase of the transition, the sustainability of this strategy in the long run remains to be seen. Lawlessness cannot work in the long run, and as transition economies gradually establish more legislation and regulations backed by credible law enforcement, these gray organizations will have to confront increasing pressures for legitimization. The CEO of Bulgaria’s Multigroup perhaps provided the best advice on a future strategy that might be called tail cutting: “The lizard survives if it cuts off its tail. It’s time for our [illegal] economic groups to cut off their illegal tails.”

While analytically distinct, these three entrepreneurial strategies are not necessarily separate in practice, and are often employed concurrently by startups. In other words, a startup can adopt a prospector or guerrilla strategy, while engaging in intense networking that blurs the public-private and/or legal-illegal boundaries.

**What Can Be Learned?**

The development of entrepreneurship throughout transition economies has generated important lessons for entrepreneurs in these economies, as well as for foreign entrepreneurs and managers interested in these emerging markets.

*Lessons for entrepreneurs in transition economies*

**Dealing with environmental turbulence**

At the dawn of the new millennium, the political, social, and economic environment in many transition economies continues to be characterized by turbulence, which is not likely to stop soon. In CEE and the NIS, the transition brought hyperinflation in the early 1990s, which was tamed only by the mid-1990s. Then came the Russian crash in 1998, which not only sparked a collapse of Russia’s financial system, but also forced countries across the region to brace themselves against contagion. In China, although the constitution was finally amended in 1989 to catch up with reality by acknowledging the private sector’s important role in the economy,\textsuperscript{36} the government has continued to behave unpredictably. In 1998, it banned direct marketing without any public consultation, despite nearly $200 million invested by American firms such as Amway, Avon, and Mary Kay, and an estimated involvement of 20 million Chinese entrepreneurs. In 1999, the government in a similar manner announced a ban on all foreign investment in Chinese Internet-content providers, most of which are entrepreneurial startups.\textsuperscript{37}

Despite its complexity and unpredictability, environmental turbulence seems to be a major catalyst for entrepreneurial activity in transition economies. The more dynamic, hostile, and complex the environment, the higher the level of innovation, risk-taking, and proactivity among the most successful entrepreneurial firms.\textsuperscript{38}

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Three ways of dealing with environmental turbulence in transition economies can be identified:

- **Establish alliances with larger, more legitimate, and more powerful players.** This is the heart of networking and boundary-blurring strategies discussed earlier. Partners in these alliances can include more established domestic firms, as well as foreign entrants and certain government agencies. From foreign entrants, entrepreneurial firms can gain access to financial assets and learn managerial and technical capabilities.\textsuperscript{39} Teaming with government agencies allows startups to tap into the resources of these partners, thus helping deter environmental turbulence for entrepreneurs. Lucky Transportation’s efforts to register as a collective firm and join an enterprise group in China serve as a case in point. For the same reason, many private Inter-
net startups in China have investment from government-run Internet providers.

- **Take collective action to promote entrepreneurial development.** As a new organizational form, private startups are misunderstood by many people in certain transition economies, who associate these firms with criminal organizations. Entrepreneurs should mobilize to form industry or business owners’ associations in order to lobby the new government, the media, and the public about the wealth-creation role they play in the economy. Of course, similar to lizards sacrificing their tails, gray organizations with criminal or dubious backgrounds may have to cut off their illegal tails in order to advance their legitimate interests.

- **Create linkages with established educational institutions.** Collaboration with educational institutions confers legitimacy on entrepreneurs among the future generation of employees and entrepreneurs. Entrepreneurs can also access researchers in these institutions, whose findings may further disseminate the role of entrepreneurship in transition economies. As a result, many startups, after they survive the first stage, often establish linkages with educational institutions through scholarships, internships, and research support. The importance of such linkages is especially noted by professional-entrepreneurs, such as those running Russia’s Vimpelcom.

Transforming raw entrepreneurship into strategic leadership

While these tactics for dealing with environmental turbulence focus on strategic alliances and collective actions, recent research suggests that smaller, entrepreneurial firms may face an inherent disadvantage when collaborating with larger and more powerful players. Entrepreneurs may have better odds for success if they can develop capabilities that allow them to stand on their own and grow the firm. One key enabler is to focus on strategic leadership, defined as the “ability to anticipate, envision, maintain flexibility, think strategically, and work with others to initiate changes that will create a viable future for the organization.” This capability has been argued to be a major factor differentiating the winners from the losers in the new competitive landscape of the 21st century.

With little exaggeration, most early entrepreneurial strategies in transition economies can be viewed as highly opportunistic, making the first move to fill many unfilled gaps. This is precisely the heart of a prospector or guerrilla strategy. As transitions deepen and competition becomes more saturated, a higher level of entrepreneurial capability—namely, strategic leadership—will be required to transform such raw entrepreneurship. Specifically, entrepreneurs need to:

- **Develop and communicate a long-term strategic vision.** While entrepreneurs might operate without a clearly articulated strategy when the organizational size is small, developing an explicit, long-term strategic vision becomes more critical for increasingly larger organizations. Such an ability seems to characterize the best-performing startups, such as China’s Hope Group and Russia’s Vimpelcom. Increasingly, the need to strategize is felt among entrepreneurs interested in taking their business to a new height.

- **Build dynamic core competencies.** The days when entrepreneurs could hit and run in the early stages of the transition seem to be passing. The new competition requires sustained investment in core-competencies-based strongholds that can be defended and strengthened, often leading to a deep-niching strategy for many entrepreneurial firms. These core competencies have to be dynamic, and be continuously updated and extended. Facing gigantic multinationals targeting these economies, the built-in flexibility of entrepreneurial firms resulting from their small size and informal structure may be especially helpful. Poland’s Optimus Computer can serve as a vivid case in point.

- **Focus on human capital.** Given their thin resource base, entrepreneurial firms must compete on resourcefulness, the ability to do more with less. Making the most of the human capital of their employees becomes critical. Entrepreneurs should seek to not only hire, train, and invest in the best talents, but also to make sure that such human capital stays within the firm as it grows. A hurdle that entrepreneurial firms like China’s Hope Group need to overcome is family-style management, which tends to rule out criticism of the boss and discourages creativity. Few employees aspiring for top posts will be satisfied with an organization that will not allow them a role in business strategies. The ability to motivate and retain talented employees may become a source of competitive advantage for entrepreneurial firms.

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The ability to motivate and retain talented employees may become a source of competitive advantage for entrepreneurial firms.
• **Make effective use of new technology.** While the technological base of most established firms in transition economies is obsolete, many entrepreneurial firms are uniquely positioned to leapfrog by acquiring some of the latest technology in sophisticated manufacturing and services. Recent examples are the numerous Internet startups popping up in these economies. These new startups change the low-tech, labor-intensive image of many entrepreneurial firms in transition economies, and push both the scope and pace of technological progress to new levels. Given the lackluster performance of many SOEs and privatized ex-SOEs in these economies, entrepreneurial startups may offer these countries the best hope of catching up with the global technological race.

In sum, these lessons for current and would-be entrepreneurs in transition economies call for continuous management of environmental turbulence and fundamental transformation from raw entrepreneurship to strategic leadership. Similarly, important lessons can be drawn for foreign entrants.

**Lessons for foreign entrants**

Up to this point, most of the interactions that foreign firms have with local firms in transition economies are with larger SOEs as joint-venture partners or ex-SOEs as acquisition targets. As the entrepreneurial sector becomes more established in these countries, however, some of these firms will become attractive partners or targets for foreign entrants. Without much research to draw from, the lessons for foreign entrepreneurs and managers interested in working with entrepreneurs in transition economies are more tentative and speculative. In general, foreign entrants need to:

• **Treat entrepreneurial partners sensibly.** Even for foreign companies experienced in the region, very few have so far dealt with smaller, entrepreneurial firms. How to treat these entrepreneurial firms differently from SOEs remains a major task for interested foreign entrants. Some of the assumptions that foreign companies hold with regard to SOEs—such as that they have inefficiency and governance problems—may not be applicable to startups. Typically, the first step in restructuring firms in transition economies is a very costly, difficult, and time-consuming process of conversion from SOEs to market players. This process may not be necessary when working with private firms. The new breed of entrepreneurial ventures, which are smaller, younger, and more aggressive, can be regarded as the opposite of SOEs in market orientation. Therefore, foreign entrants may need to unlearn some of the ungeneralizable prior notions about firms in transition economies (e.g., the need to teach Marketing 101 and Finance 101), when working with entrepreneurial startups. Smaller firms in transition economies may provide unique resources attractive to the larger, more resource-rich foreign entrants, such as market knowledge and specialized skills. At the same time, new ventures in transition economies may share certain similarities with SOEs and recently privatized firms, such as a short-term mentality and a lack of interest in continuous learning. Therefore, foreign firms' experience in transforming SOEs, such as ABB in Poland, may be helpful. In particular, foreign entrants may need to simultaneously restructure both hard (structures) and soft (human resources) aspects of the acquired firms, instead of handling one aspect at a time in a piecemeal fashion.

• **Take collective action to promote mutual interests.** The stronger and more effective the collective actions of foreign entrants, the more likely their goals—which usually include market opening and legal reforms in transition economies—will be accomplished. Industry and trade associations representing foreign business interests in transition economies, such as the U.S.-China Business Council and the Working Committee on Eastern Europe of the European Council for Small Business, have become increasingly visible. For example, facing the Chinese government's bans on direct marketing and Internet investment in 1998 and 1999, respectively, American direct-marketing companies and Internet venture-capital firms pressed their cases through U.S. trade negotiators in China's World Trade Organization talks, and eventually obtained significant concessions from the Chinese side.

• **Establish alliances.** The rationale behind foreign entrants' need to use alliances is similar to that of domestic entrepreneurs. However, such an alliance strategy does not necessarily lead to joint ventures. In certain knowledge-intensive industries, foreign entrants may have little choice but to establish wholly owned subsidiaries to protect their intellectual assets. Nevertheless, wholly owned subsidiaries can still pursue alliance strategies with larger and more powerful players. When encountering extensive software piracy in China, Microsoft, through its wholly owned subsidiary, chose to collaborate with the Ministry of Electronics to develop new software, instead of challenging the government head-on.
Microsoft figured that once the government has a stake in the sales of legitimate Microsoft products, it may also have a strong interest in using its clout to crack down on sales of counterfeit software. In essence, Microsoft followed its entrepreneurial counterparts in China by wearing a "red cap" in order to accomplish its goals.

Research suggests that foreign-led turnaround and restructuring of firms in transition economies, which so far have been limited to current and ex-SOEs, can succeed despite the difficulties. Such development is encouraging for foreign companies interested in restructuring entrepreneurial firms in transition economies. After all, the founding principles (e.g., private ownership, profit maximization) between foreign firms and entrepreneurial firms in the region have a better fit than the radical contrasts between foreign firms and SOEs. Given the expected increase of foreign firms' dealings with entrepreneurial firms in transition economies, following some of the tentative lessons above should increase the odds for successful interactions over those with SOEs.

Some caveats

The outlook for entrepreneurship in transition economies is not always rosy. Entrepreneurship does not always create wealth. Many entrepreneurs in transition economies have not created wealth, but appropriated or redistributed wealth in their favor. Given that many entrepreneurial undertakings are clouded by gray activities, how entrepreneurship can be developed in an ethical and legal manner that is sustainable in the long run is important. Although in the short run, some gray or illegal activities serve a role that is economically functional, accepting these activities as a legitimate and natural by-product of economic transitions is dangerous in the long run. While providing arbitrage profits to certain intermediaries, such as former cadres, these activities may create new distortion in the economy, deter foreign investment, and generate public resentment toward all entrepreneurs, legitimate or otherwise.

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Since individual entrepreneurs, however enlightened, may be unable to deter the tide of gray activities, policymakers need to seriously curtail these activities by clearly delineating and enforcing the rules of the game. It is fair to say that most transition economies have made considerable, if not uniform, progress in establishing basic institutional frameworks. However, they have usually achieved greater progress in the extensiveness than in the effectiveness of the laws and regulations. The private enforcement of contracts, sometimes through illegal means, has emerged as a response to the failure of the state to provide and enforce its own rules. Therefore, cracking down on the illegal enforcement services of the gray economy will not succeed until public law enforcement is sufficiently developed.

Governments should also minimize the possibility of harassment against entrepreneurs by rent-seeking officials. Instead of being viewed as a softer invisible hand, the government is often viewed as a greedy, grabbing hand in countries such as Russia. Facing such a predatory regime, many existing entrepreneurs may continue to be drawn into the gray economy and interested only in short-term profits, and many more would-be entrepreneurs will simply give up on their ideas. Simplification of tax rules and reduction of marginal rates will draw more firms out of the unofficial gray economy. They will also make it less likely for rent-seeking officials to succeed, because transparency of the rules creates little room to maneuver.

Creative Destruction

Despite different paces and results, the entrepreneurial transformation of transition economies takes on increasing importance. How do entrepreneurs and the startups they found create wealth in these environments traditionally hostile to entrepreneurship? A short answer is that they accomplish this through aggressive prospector and guerrilla strategies, extensive networking, and active boundary-blurring. The lessons that can be learned all center on enhancing entrepreneurial startups' competitive advantage and, by extension, promoting the entrepreneurial spirit of these economies. Since entrepreneurship inevitably implies a deviation from customary behavior in any country, entrepreneurs in transition economies are not without controversy, leading to caveats about some of the practices of the new competition.

This article has opted for a generalization approach. While the lessons are derived from a multinational triangulation process based on the experience of practitioners, advice from officials and advisors guiding the transitions, and the findings of scholars, overgeneralization must be
avoided. Every transition economy is different. The lessons for Poland's relatively more developed economy are not likely to be the same as those for Vietnam's or Belarus's less developed economies. For large countries such as China and Russia, regional differences within a country are also enormous, again making overgeneralization dangerous. The history of economic transitions in the past two decades suggests that what transition economies need is not a set of standard lessons, recipes, or packages, but rather institutional and organizational experimentation to allow for the evolutionary emergence of entrepreneurship.54

Entrepreneurs create wealth throughout transition economies using a "creative destruction" process that Joseph Schumpeter first highlighted. In essence, startup firms create an alternative organizational form that challenges and may eventually destroy the state sector. Although entrepreneurs are pursuing their private gains and are not concerned with official ideology, they collectively become participants in a great social movement whose invisible hand pushes a bankrupt, socialist regime aside. Such wide-ranging transitions manifest the staggering, creative and destructive power of entrepreneurship and competition—both for the entrepreneurs who participate in the transitions and for the economies that embrace them.

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Endnotes


5 Local governments in South China, such as those in Guangdong Province, are more accommodating and friendly to entrepreneurs. See Chang & MacMillan, op. cit.


7 The CEE figure is reported by Mugler, op. cit. The U.S. and Western European percentages can be found in Aldrich, H. 1999. Organizations evolving. London: Sage, 75.


9 The value-neutral term gray economy is used here for compositional simplicity. Other terms include labels such as the second, semiprivate, shadow, underground, and unofficial economy.

10 While mafia practices are clearly unethical and illegal in both transition and developed economies, using personal favoritism and grease payments to get things done and ignoring tax laws and regulations, which tend to be considered unethical in developed economies, are often regarded as largely acceptable and even ethical in transition economies. Some unacknowledged and hence unethical practices in the West, such as layoffs and whistleblowing, are considered to be unethical in Russia. See Puffer, S., & McCarthy, D. 1995. Finding the common ground in Russian and American business ethics. California Management Review, 37: 29–46.


19 In general, small firms—regardless of locations—tend to be unwilling to invest in R&G. However, in eastern Germany, they are less than half as likely to undertake R&G as their western counterparts in unified Germany. See Audretsch, op. cit.


24 Peng & Luo, 2000, op. cit.


26 Although bribery was used in this case, it is not a practice to be recommended. Most entrepreneurs such as those running Lucky Transportation seem to have a resort to bribery to get things done. However, if they refuse to pay while competitors do, then entrepreneurs who do not pay bribes may be disadvantaged in terms of market opportunities and resources. This dilemma is similar to the one confronting many U.S. firms abroad, which are constrained by the Foreign Corrupt Practices Act. See Hill, C. 2000. International business, 3rd ed. Boston: Irwin; Vogt, F. 1998. The supply side of global bribery. Finance & Development, June: 30–33 (especially p. 30).


30 Peng, 2000, op. cit., 186–188.

31 The nonstate firms in Table 2 include not only registered, pure private firms, but also collective (private-public hybrid) firms, and foreign-invested firms. Therefore, we may safely infer that the percentage of loans obtained by registered private firms is substantially smaller than the meager 15.9 percent figure obtained by all three categories of nonstate firms in 1996.


34 Ibid.


38 Morris, op. cit., 65.


46 Oblec, K., & Thomas, H. 1998. Transforming former state-


Puffer & McCarthy, op. cit.


Mike W. Peng is an assistant professor of management at the Fisher College of Business, The Ohio State University. He holds a Ph.D. from the University of Washington. He has widely published in leading journals, served on the editorial boards of the Academy of Management Review and Journal of International Business Studies, and authored Business Strategies in Transition Economies (Sage, 2000). Contact: peng.516@osu.edu.

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Executive Commentary

Stanislav V. Shekshnia
Millicom International Cellular, Russia and CIS

Today 1.5 billion people live in countries in transition from centrally planned to market economies. This group of countries is very heterogeneous, including nations such as China, Poland, Russia, and Uzbekistan, that differ in levels of economic development, culture, and history. At the same time, all share a desire to catch up with the developed world and become one day as rich as the Western nations. I believe that two factors will determine if it is going to happen or not: level of education and level of entrepreneurial activity. History shows that these two things contribute significantly to the long-term prosperity of any nation.

Therefore, it is extremely important that we study entrepreneurship in transition economies and look at ways it creates wealth. I see a number of specific reasons why this subject is so important today. First and foremost is the need to change attitudes toward entrepreneurship in transition economies. Unfortunately, after 50 or 80 years of communism, the attitude to entrepreneurs is negative in most of these economies. The task of scholars and journalists is to demonstrate that entrepreneurs are the drivers of economic progress, people who create wealth for the whole society. They should be seen as national heroes, as they are in America.

The example of some Central European countries shows that this could be done. Attitudes toward entrepreneurship in these countries have changed dramatically over the last 10 to 15 years. I believe it is strategically important for these societies to make entrepreneurs role models for their younger generations. Young people should dream about entrepreneurial careers and prepare for them. This will ensure the economic development of their countries.

Young people should dream about entrepreneurial careers and prepare for them. This will ensure the economic development of their countries.

The second major reason to study entrepreneurship is educational. As Mike Peng shows, entrepreneurs come from different strata of the transitional societies, but they have one feature in common—few of them studied entrepreneurship in a classroom. So it is important for a society to educate its entrepreneurs themselves. It is important to pass on to them some collective knowledge that could be extracted from the 10 years of entrepreneurial activity in transition economies. It is probably even more important to educate people who will become entrepreneurs in three, five, or 10 years and will compete in the global economy. I regard Peng’s article as an important building block in a tower of knowledge about entrepreneurship in transition economies.
Looking at where entrepreneurs come from, one sees similarities with the developed economies—with the exception that transition economies have a much higher percentage of entrepreneur-criminals. We also see in transition economies, at least in countries of the former Soviet Union and Central Europe, two trends worth mentioning. The first is the high level of correlation between the level of education and entrepreneurial activity. Most entrepreneurs in these economies have college degrees. Very few people without formal education become successful in their own businesses. The second trend is that a very high number of entrepreneurs, maybe more than 50 percent, set up businesses unrelated to their previous professional activity. Doctors create trading companies, engineers become entertainment magnates, and linguists set up travel agencies. There is very little correlation between professional training or previous career and the entrepreneurial activity selected.

Going back to the most important question of the article—how entrepreneurs create wealth—I think Peng provides an excellent answer. Entrepreneurs create wealth by serving the real needs of people; if they don’t, they go bankrupt. Entrepreneurial companies don’t have the luxury of cheap loans or huge cash reserves. If we look at the countries of Central Europe and the former Soviet Union, the relative prosperity they enjoy is largely due to entrepreneurs.

That entrepreneurs in transition economies work primarily in the service sector is not surprising. This sector was an underdog under socialism, since the communist party believed that heavy industry determined the wealth of a nation (and its military might). As a result of this policy, former communist countries faced an enormous shortage of consumer goods and services. Since service businesses are usually labor-, not capital-intensive, entrepreneurs moved straight into the service sector. Thanks to their creativity and hard work, the service sector has undergone a dramatic change over the last decade, becoming a primary source of new wealth and employment growth. Russia’s service sector represents about 55 percent of the economy today, compared with 41 percent in 1990.

As Peng points out, flexibility traditionally distinguishes entrepreneurial organizations. This feature serves them extremely well in transition economies. That is how they beat huge state-owned or huge privatized corporations. Entrepreneurs are hungry for new opportunities; they move from one product to another, from one industry to another, from one geographical location to another. The speed is extremely fast, and large organizations simply can’t follow them. The story of one of the leading financial industrial groups in Russia is exemplary. The group started in 1989 as a small cooperative producing film for cameras. A year later, the entrepreneurial founders moved into computers. When the margins were squeezed in the computer business, they moved on to the food business. After foodstuffs, they diversified by acquiring assets in oil and sugar, creating a supermarket chain, and a number of trading houses. Today the group has $3.5 billion in revenue, with significant interests in oil exploration and extraction, commodities trade, retail, and one of the largest commercial banks in the country.

Peng questions whether entrepreneurial flexibility will allow successful startups to remain their competitive edge when large organizations move into the new field created by entrepreneurs. This is a critical test for any venture’s longevity—to preserve flexibility when size increases. The group above does it by spinning off its new businesses as soon as they become self-sustaining financially, and keeping its core company (incubator for future ventures) relatively small and entrepreneurial in its culture. They also bring in people with relevant expertise and let them run startups.

Flexibility and the ability to blur boundaries are often conditions for innovation. I would suggest that the ability to innovate is a fundamental factor for the success of any company in today’s economy. I disagree that the importance of this competence diminishes as the company grows and passes the entrepreneurial stage. Of course, small companies have some natural advantages to be innovative, but if they are to stay competitive they have to keep this competence no matter how big they are.

The question that arises as one reads this very balanced article is how to sustain momentum, how to make sure entrepreneurial companies set up in transition economies during the last 10 years remain successful in the long run. Like Peng, I see two major challenges that will determine entrepreneurial companies’ success when they enter a new stage of their development. The first challenge is professional management—how to ensure a transition from a small, often family-style business to a large multimillion-dollar corporation. We see a lot of failures at this stage. Many owners could not become professional managers and their companies perished with them. The example of Vimpelcom mentioned by Peng is a very characteristic one. The founder and CEO of the company who lacks managerial talent has been struggling with this issue for some years, while his company is
losing its market share to a professionally managed competitor. We all know how difficult it is for an entrepreneur to give away control over his or her baby to somebody who had nothing to with its creation. But the time usually comes, and it becomes imperative to make this change. I don’t believe that you cannot teach an entrepreneur professional management skills; however, I think it is the exception for a good entrepreneur, who sets up a business by grasping early opportunities, to become a good general manager. And it is extremely important for entrepreneurs to realize this.

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I see three solutions to this challenge. The first one is simple—to hire professional managers and give them operational control over the company. Emotionally, it is the most difficult to do, but in most cases it is inevitable. Going back to the example of the industrial group I mentioned earlier, its founder felt at some point that it was very important for the company to create a bank. They did create the bank, but since he was an engineer by training, not a banker, he did not know much about how to run it. Therefore, from an early stage he hired a professional manager, an American banker, to run the bank, which became one of the most successful banks in the country.

The second solution is to bring in a strong partner with a competence in management. That would usually be a large, older corporation. For transition economies, that would often be a foreign partner, since their history of professional management is too short. That is the way Vimpelcom has chosen, by bringing in Norwegian telecom giant Telenor and giving it 25 percent of the equity. This gives access to foreign know-how, primarily in management, but at the same time it is usually easy for the founder to accept this equity transaction than to just bring in managers from outside.

The third way—to sell the company—may be more dramatic, but it could be very efficient to sell the company, to cash in, and move on to create a new venture. Instead of struggling with learning professional management skills, entrepreneurs can use proven competencies in starting new businesses. I know one Russian entrepreneur who sold his Internet company to develop a fast-food chain. It was the seventh company he had created and sold.

The second major challenge the article acknowledges is an ethical one. In the early days, as Peng shows, entrepreneurs were coming from different backgrounds, including criminal pasts, legal boundaries were unclear, a legal mechanism of ensuring contracts did not exist, and old communist values collapsed. “Grab what you can” was a popular motto. But as the times change, it is very important for entrepreneurs to realize that if they want to be successful in the long term they have to adopt the same fundamental values that were instrumental in creating wealth in industrialized economies. In simple words, you can fool people once or maybe twice, but the third time they will deal with somebody else. I see business ethics as the biggest challenge and the most important precondition of prosperity for transition economies.

If entrepreneurs can embrace values of honesty, hard work, trust, and consistency, then transition economies are in a good position to succeed. Central European countries provide some very encouraging signs. As the CEO of a Bulgarian company said: “It’s time for our economic groups to cut their illegal tails.” They realized that it is profitable to be honest with your counterparts. This is the guarantee of their long-term success. But if you look at Russia and the other countries of the former Soviet Union, the question is not clear. There are still a lot of black or questionable deals and dishonest behaviors, and there is still a very high percentage of people who call themselves entrepreneurs while they are simply robbing the state and its people of assets. If this tendency prevails, if Western values are not embraced by the entrepreneurs in these newly independent countries, their future is going to be bleak.

Stanislav V. Shekshnia is president and CEO of Millicom International Cellular, Russia and CIS, a company operating 14 cellular networks in the former Soviet Union. Dr. Shekshnia is also a visiting professor at the Paris Graduate School of Management (ESCP/EAP) and at California State University, Hayward (Moscow campus). He has an MBA from Northeastern University and a Ph.D. from Moscow State University. Contact: stas@online.ru.