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The Logic of Management Consulting

(Part One)

STAFFAN CANBACK

EDITOR'S NOTE:

In this first of a two-article series, "The Logic of Management Consulting," Staffan Canback, a consultant at Monitor Company, traces the history and trajectory of the management consulting industry and introduces transaction cost theory. In the second article in this series, Canback will use transaction cost theory—originally developed in the 1930s by Ronald H. Coase—to help explain the existence and phenomenal growth of this industry.

Transaction cost theory has several applications in economics and management. One of the most important is to help explain the boundaries of firms—why certain activities, products, or services are carried out internally in firms while others are bought and sold in the marketplace. As such it is a useful framework for thinking about management consulting services. Why, after all, do executives hire consultants when they might do the work themselves?

Despite current popularity and astounding growth rates, management consulting remains one of the least researched and written about industries (Gagnon, 1984). We take for granted that the industry should exist and function in the way it does. Yet the tremendous growth of the management consulting industry over the last twenty years cannot be easily explained. As Bernie Ramsbottom of the *Financial Times* (April 11, 1981) put it:

Of all the businesses, by far
Consultancy's the most bizarre.
For to the penetrating eye,
There's no apparent reason why,
With no more assets than a pen,
This group of personable men
Can sell to clients more than twice
The same ridiculous advice,
Or find, in such a rich profusion,
Problems to fit their own solution.

Solely for purposes of analysis in this and next issue's article, I will define *management consultants* as those who provide general management advice within a strategic, organizational, or operational context, and who are institutionally organized in firms. It excludes other types of consulting, and it excludes management consultants who are not institutionally organized. My estimate is that the chosen segment of the consulting market accounts for around 30 to 40 percent of total consulting revenues, and 80 percent of management consulting revenues.

What is management consulting? According to Greiner and Metzger (1983):

> [M]anagement consulting is an advisory service contracted for and provided to organizations by specially trained and qualified persons who assist, in an objective and independent manner, the client organization to identify management problems, analyze such problems, recommend solutions to these problems, and help, when requested, in the implementation of solutions.

Application of a powerful analytical tool demystifies the economic forces driving management consulting's phenomenal growth and helps visualize alternative future scenarios.

L'application d'un puissant instrument analytique démystifie les forces économiques à l'origine de l'incroyable développement des conseils en gestion d'entreprise, et facilite la visualisation d'autres scénarios futurs.

Die Anwendung eines leistungsstarken Analysehilfsmittels entmystifiziert die wirtschaftlichen Kräfte, die das phänomenale Wachstum von Managementberatungen ausmachen—und hilft bei der Vorstellung alternativer Zukunftsszenarien.

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There are a few key words in this definition. *Advisory service* indicates that consultants are responsible for the quality of their advice, but they do not substitute for managers and have no formal authority. *Objective and independent* indicates financial, administrative, political, and emotional independence from the client (Kubr, 1996). *Trained and qualified* shows that a consultant is more than the individual and his or her personal experience. As you will see, these elements in the makeup of management consulting sometimes contribute to the demand for external consulting services, and sometimes detract from it.

Background

Within the context of the above definition, management consulting has a long history (see Moore, 1982; Kubr, 1996; UNCTAD, 1993). The first management consultants appeared around the turn of the century and included individuals such as Frederick Taylor, Henry Gantt, Arthur D. Little, and Harrington Emerson, all of whom are still famous for their contributions to the science of management. Little and Emerson also started two of the first consulting firms. These pioneers were mainly concerned with operational efficiency issues such as Taylor's time-and-motion theory.

Between 1910 and 1940, a second generation of consultants expanded the concept of management consulting. Edwin Booz started offering "business research services" in 1914, and James O. McKinsey started McKinsey & Company in 1926. In Europe, Lyndon Urwick and Charles Bedeaux were pioneers who contributed extensively to defining management consulting in the 1920s. These consultants pioneered or implemented techniques such as budgeting processes, the divisionalized organization, merit-based compensation schemes, and forecasting techniques.

During the early post-war years, and in many cases growing out of wartime experience, consulting experienced a big surge, with the formation of such firms as Cresap, McCormick & Paget, William E. Hill, Bruce Payne & Associates, Hay Associates, and Towers Perrin.

Three major developments took place in the 1960s. First, Bruce Henderson moved from the Arthur D. Little firm to start the Boston Consulting Group in 1963 and more or less single-handedly operationalized the concepts of strategy and strategy consulting. Out of this sprang a second generation of strategy specialists such as Bain & Company, Strategic Planning Associates, Braxton Associates, LEK Partnership, and Monitor Company.

Second, the major accounting firms started responding to the growth of management consulting and created management advisory service groups to augment their core accounting practices. Today the consulting practices of Andersen Worldwide, PricewaterhouseCoopers, Deloitte & Touche, and Ernst & Young often rival the accounting activities of these firms in size.

Even as late as 1980, despite a growing proliferation of specialties, management consulting was still in its infancy as an industry.

And third, also starting in the 1960s with the emergence of Cambridge Research Institute and Management Analysis Center, firms institutionalizing the combined consulting practices of leading academics and practitioners began to make their presence known.

An Emergent Field

Even as late as 1980, despite a growing proliferation of specialties, management consulting was still in its infancy as an industry with perhaps around 18,000 practicing management consultants worldwide, and only 30 to 40 percent of these employed in the large, institutionally organized firms of the type mentioned above[1] (*Consultants News,* 1982–1997; Payne, 1986). Even the largest consulting firm in those days, Booz•Allen & Hamilton, had revenues of only around $150 million. The industry as a whole had revenues of $1.2 billion in the United States, and worldwide perhaps $2 billion.

Over the next seventeen years, the management consulting industry grew to around $35 billion globally. The annual growth rate has been more than 20 percent. Today there are approx-

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imately 140,000 consultants worldwide (a considerable percentage of the more recent growth is accounted for by information-technology projects manned less by management consultants than by systems integration specialists).

This growth is impressive, but the true importance of the industry's evolution is the accumulation of institutional knowledge. In 1980 there were less than five consulting firms with more than 1,000 consultants. Today, there are more than thirty. If the experience curve applies in consulting services, then it may be noteworthy that approximately 80 percent of all consulting experience was generated in the last seventeen years, and only 20 percent in the period from 1886 (when Arthur D. Little started the first consulting firm) to 1980. As we will see, this has had profound implications for the division of labor and the balance of power between consultants and clients.

Management Consulting's Importance

More than just a growth industry, management consulting in and of itself is one of the most important and enduring management techniques developed over the last fifty years. A secondary effect of this invention has been the rapid dissemination of new frameworks, tools, and techniques in large companies.

Surprisingly, however, not much has been written about this phenomenon. In part, it could be because few are interested in the topic—it is still seen as an admission of failure by many managers to use consultants, and who wants to read about failure? In part it could be because the management consulting firms are highly secretive, and thus difficult to analyze and understand.

A few facts and observations do speak for themselves. Management consulting firms today employ around 25 percent of the graduates from the leading business schools, and those graduates are usually among the top performers in their class. Some traditional companies have essentially given up recruiting at these schools because consulting firms and investment banks can offer what is perceived as more career opportunity, better pay, and a more stimulating environment than traditional companies in the manufacturing or service sectors.

Another aspect is that today there are approximately 70,000 management consultants in the United States, compared to around 150,000 executives of the type consultants normally interact with at firms governed through "complex" management (Granovetter, 1984). That is, for each executive there are 0.5 management consultants who advise, full time. In 1980, this ratio was approximately 0.1. Clearly, and without inferring any judgment on the relative contribution of executives and consultants, the balance of influence is shifting dramatically.

Finally, several industry observers, including Payne (1986), argue that innovation in areas such as strategy is dominated by management consultants, and not by managers or academics. The same is probably true for other management disciplines. Take, for example, reengineering in its various incarnations (though an academic figured mightily in launching this specialty).

Consequently, management consultants have had a large impact on the state of management due to both the quantity and quality of contributions. Yet, this does not explain why management consultants "exist." It is not clear why managers would want to give away so much of their companies' intellectual agenda to outsiders. It is not obvious why it is more cost effective to hire experts from the outside than to do the same work internally in companies. And even if it were, why is this happening on a massive scale now, and not sixty years ago? Why is it happening in the United States, for example, but only to a limited extent in Japan?

Before addressing these issues, the next three sections build a platform of understanding the task of management consultants, and the basics of transaction cost theory, by reviewing the relevant literature.

Management Consultants' Roles and Tasks

Schein (1988) categorizes management consultants with respect to the role they play in their interaction with clients. He distinguishes between three models of consultation: purchase

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of expertise, doctor-patient, and process consultation.

The purchase-of-expertise model is used by clients who require the consultant to bring their own independent perspective on the industry and the issues at hand. In its purest form, the consultant is not expected to interact extensively with the client but rather to provide his or her expertise in a hands-off relationship.

In the doctor-patient model, the consultant emphasizes his or her diagnostic capability by carefully analyzing the client organization's problems. Using their often unique experience base and diagnostic skill, consultants quickly assess strategic and organizational blockages. This model leads to an intimate and often trust-based relationship between the consultant and the client.

The process-consultation model builds on the notion that the consultant is the facilitator, while the client contributes the expertise. Thus, there is a clear division of roles and tasks. The client ultimately chooses what to do about a problem. The consultant, on the other hand, provides a methodology for defining the problem and finding the best possible solutions. The similarity to psychological analysis methods is not coincidental. Schein's classification reflects a range of roles, from the consultant as a content provider to the consultant as a process provider. A similar segmentation is suggested by Nees and Greiner (1985), who divide strategy consultants into five categories:

1. The "mental adventurer" analyzes truly intransigent problems such as long-term scenarios for country development, by applying rigorous economic methods and leveraging his or her experience base.
2. The "strategic navigator" bases his or her contribution on a rich quantitative understanding of the market and competitive dynamics, and then recommends courses of action without too much regard of the client's own perspective.
3. The "management physician" derives his or her recommendations from a deep understanding of the internal dynamics of the client organization, often willingly sacrificing some objectivity to gain a realistic perspective on what is achievable.
4. The "system architect" impacts his or her clients by helping redesign processes, routines, and systems—always in close cooperation with the client.
5. The "friendly co-pilot" counsels senior managers as a facilitator rather than as an expert, and has no ambition to provide new knowledge to the client.

The mental adventurer broadly corresponds to Schein's expert model; the strategic navigator, management physician, and system architect correspond to his doctor-patient model; and the friendly co-pilot is similar to the process-consultation model.

Nees and Greiner further show that institutionally organized strategy consultants are found primarily in the strategic navigator and management physician segments. The Boston Consulting Group, Bain & Company, and Monitor Company are examples of the former, and McKinsey & Company of the latter. Clearly, the role of the consultant in both segments requires a relationship between client and consultant that goes beyond a contractually specified arms-length relationship.

For each executive there are 0.5 consultants who advise, full time.

Turner (1982) uses a hierarchy of tasks to demonstrate the extent of a consultant's involvement with a client. He argues that until the late 1970s, the consultant often worked as a supplier to the client, but that the relationship increasingly is built on a partnership of mutual respect aimed at fundamentally improving the client's effectiveness. Turner uses eight task categories to delineate management consulting approaches. The first five correspond to the traditional arms-length supplier status, the last three are newer, evolving tasks:

1. Providing information to a client
2. Solving a client's problem
3. Making a diagnosis, which may necessitate redefinition of the problem
4. Making recommendations based on the diagnosis
5. Assisting with implementation of recommended actions

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6. Building a consensus and commitment around corrective action
7. Facilitating client learning
8. Permanently improving organizational effectiveness.

Most management consulting firms today aspire to work on the higher-value added activities at the lower end of the list. Thus, it is once again clear that management consultants' relationships with their clients are becoming increasingly complex, and that these relationships rely more and more on sophisticated contractual arrangements of primarily informal nature, such as trust. However, research has also shown (Leontiades and Ahmet, 1989) that management consultants still have a long way to go before they exert major influence on the core issues of their clients. A chief executive is more likely to be influenced first by his or her own instincts and thinking on a particular subject, followed by the planning staff, the board of directors, and investment bankers, than by consultants. Thus, it is unclear how far down the task hierarchy management consultants have really moved.

Practitioners' Views

Marvin Bower (1982), the driving force behind McKinsey & Company over almost half a century, suggests six reasons why hiring external consultants makes sense in many situations: (1) they provide competence not available internally, (2) they have varied experience outside the client, (3) they have time to study the problems, (4) they are professionals, (5) they are independent, and (6) they have the ability to create action based on their recommendations. However, he does not make clear why most of these statements should be true.

In large companies, the core market for management consultants, most of the skills provided by consultants should ostensibly be available internally because large companies have encountered most classes of problems. Arguably, creating the time to study a problem should simply be a matter of priority setting. That the degree of professionalism is automatically higher within a consulting firm is not obvious. Furthermore, there are arguments both for and against the proposition that consultants are more independent than internal managers and experts. Finally, the superior ability to create action, attributed to consultants by Bower, appears to be a matter of training and methods and not intrinsic to the consulting capability. Thus, only the second statement—that consultants have varied experience outside the client—appears to be correct, prima facie.

Implicit in Bower's argument, however, is the belief that consultants work primarily with Schein's first two models, the expert and patient-doctor models, since the consultant is expected to provide an independent perspective on the substantive issues at hand. In Turner's hierarchy, this corresponds to the lower levels. Bower appears to see the consultant as a partner to the client in solving unstructured, difficult problems, rather than as a supplier of packaged methods and approaches.

Bruce Henderson, the force behind the Boston Consulting Group for many years, has a similar perspective (Hagedorn, 1982). He argues that consultants add significant value to society (through their clients) by reducing the problem-solving cycle time. Exactly why management consultants have more of this capability than others is, however, unclear. But as with Bower, Henderson's implicit argument is that management consultants work together with their clients in a complicated relationship to jointly solve the problems at hand. Henderson also argues that the consultant needs to work in a specialized institutional environment that takes into account that the key resource is the body of consultants, a highly mobile resource, and that a consulting environment is characterized by instability.

Kelley (1979) makes a contrary argument to Bower and Henderson based on interviews with more than 200 internal consultants at various companies. Among other things, he argues that external consultants are more expensive than internal consultants, they are not available at the right time, and they lack an understanding of the client's environment. This reduces the external consultant's effectiveness. Kelley also predicts that the bulk of consulting work will be carried out by internal resources in the future and that external consultants will be used only for special problems and when there is a need

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to augment the internal resources. As was quantified earlier in this article, Kelley has been proven wrong by events, and the management consulting industry is today many times larger than when he wrote his article. In fact, we will see later that external management consultants are both cost effective, available, and adept at understanding their client's problems and circumstances.

The preceding summary of the literature points to a number of propositions:

- Management consultants increasingly address critical, long-term issues of their clients and are a significant part of the intellectual agenda of executives (corresponding to Turner's three lower levels).
- Consultants add value by addressing both content and process issues based on expertise, methodology, and general problem-solving skills (corresponding to Schein's expert and doctor-patient models).
- Management consultants work together with their clients in a complicated and fluid relationship characterized by a high degree of mutual trust.
- Management consultants are best organized in independent, specialized firms with unique characteristics and success factors (as argued by Bower and Henderson).

Transaction Cost Theory

The above perspectives do not shed much light on why management consultants exist. Transaction cost theory, however, may. The theory deals with the real costs of allocating resources in an imperfect world of misunderstandings, misaligned goals, and uncertainty. Since management consultants deal with this very issue, it may be that the theory can help explain the existence of this profession.

Transaction cost theory was initially developed in the 1930s by Ronald H. Coase to help explain why certain activities, products, or services are carried out internally in firms—while others are bought and sold in the marketplace. Coase's ideas were neglected for many years, but around 1970 several scholars started expanding on them. Most notable of these is Oliver E. Williamson, who over the last twenty-five years has dedicated his research to transaction cost theory issues.

Unfortunately, this massive effort has not yielded a good definition of what transaction costs are, and there has been considerable criticism of the lack of clarity and testability of the theory. The following is yet another imperfect attempt at defining transaction costs.

First, a company's costs can be classified in two categories: *production costs* and *transaction costs.* Production costs are those we are most familiar with. They are all the costs that are associated directly with productive activities (Masten, 1982) such as manufacturing, logistics, and product development. Transaction costs, on the other hand, are those costs associated with organizing economic activity. They thus vary with organizational form (Masten, 1982). Or as Kenneth Arrow (1983) puts it, "The distinction between transaction costs and production costs is that the former can be varied by a change in the mode of resource allocation, while the latter only depend on the technology and tastes, and would be the same in all economic systems." It has been estimated that at least 45 percent of the gross national product in a developed society is generated by transaction costs (Wallis and North, 1986).

> ***Management consultants still have a long way to go before they exert major influence on the core issues of their clients.***

Ronald H. Coase (1937) defined the term *transaction costs* in his pioneering work *The Nature of the Firm* by asking these fundamental questions: "Why is there any organization?" and "Why isn't all production carried out by one big firm?" His answer was that there are transaction costs that determine what is done in the market, with price as the regulating mechanism, and what is done inside the firm, with bureaucracy as the regulator. Coase pointed out that "the distinguishing mark of the firm is the supersession of the price mechanism." Within this framework, all transactions carry a cost, either as an external market transaction cost or an internal bureaucratic transaction cost. "The

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limit to the size of the firm ... [is reached] when the costs of organizing additional transactions within the firm [exceed] the costs of carrying out the same transactions through the market" (Coase, 1993). As we will see later, this is exactly the issue for management consulting. Why do companies buy this service through a market transaction rather than doing it themselves?

According to Coase (1937), the most important market transaction costs are the cost of determining the price of a product or service, the cost of negotiating and creating the contract, and the cost of information failure. The most important internal transaction costs are associated with the administrative cost of determining what, when, and how to produce, the cost of resource misallocation (since planning will never be perfect), and the cost of demotivation (since motivation is lower in large organizations). In any given industry the relative magnitude of market and internal transaction costs will determine what is done where.

Williamson (1975, 1985) extended the argument by noting that two behavioral assumptions are critical. First, individuals in an organization are boundedly rational. This, in the words of Herbert Simon (1976) means that "human behavior is *intendedly* rational, but only *limited* so." This limitation makes it impossible to structure perfect contracts, and any contract will be incomplete even if all information is available. Second, individuals behave opportunistically. This means that they will act in self-interest with guile. While some object to this strong assumption, a number of studies have shown that it is valid in organizations (Williamson, 1993), and it is a well-established tenet of Darwinian zoology (Dawkins, 1989). The implication is that promises of responsible behavior are only credible when they are supported by enforceable commitments, since individuals otherwise would break an agreement if it is in their self-interest to do so.

With the two assumptions of bounded rationality and opportunism, Williamson (1975) demonstrated that three factors play a fundamental role in determining if market or bureaucratic transactions are optimal. The factors are asset *specificity, uncertainty,* and *frequency of transactions.* Under conditions of high asset-specificity, market transactions also become expensive. By asset specificity is meant physical assets, human assets, site, or dedicated assets that have a specific usage and cannot easily be transferred to another use. Under this condition, opportunistic behavior can be expected if the asset is part of a market transaction.

An example is if a supplier invests in specific tooling equipment dedicated to one customer (or for that matter, if a consulting firm invests in a client relationship). Over time, the customer will be able to put pressure on the vendor since the vendor has no alternative use for its investment and will be willing to accept a price down to the variable cost of production to cover some fixed cost. This leads to a difficult negotiation in which each party may try to "cheat" and in which complicated safeguards have to be incorporated in the contract. On the other hand, if the customer owns the equipment, then the incentive to cheat disappears, and the cost of creating safeguard contracts is eliminated because the asset is owned by the same company.

> ***There are arguments both for and against the proposition that consultants are more independent than internal managers and experts.***

High uncertainty such as business-cycle volatility or technological uncertainty will lead to more bureaucratic transactions because it will be difficult, and prohibitively expensive, to create contracts that cover all possible outcomes. Thus, with higher uncertainty firms tend to internalize activities.

Finally, if the transactions are frequent there is once again a tendency to manage the transaction through bureaucracy since the repetitive contracting cost will be higher than the bureaucratic cost.

Empirical research has shown that the three factors above indeed do have an impact on the choice of transaction mechanism. For example, Masten (1984) demonstrated this within the aerospace industry, Teece (1981) and Klier (1993) in the automotive industry.

The final important aspect of transaction cost theory pertinent to this and next issue's article restates an argument from the beginning of this section. Transaction costs alone do not explain

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whether transactions are carried out in the market or internally in the firm. Douglass North, the 1994 Nobel Prize winner in economics, has forcefully pointed out that firms try to minimize total cost, not only transaction costs (North 1987, 1990; North and Wallis, 1994). In addition to transaction costs, a firm has production costs. Sometimes, and we will see this in the example of management consulting, transaction costs are not always minimized because the resulting improvement in production costs can outweigh the increase in transaction costs.

We can now summarize transaction costs economics in the framework shown in Figure 1. Two specific applications of transaction cost theory will be used in next issue's article.

Aoki (1990) has identified some of the basic differences between Japanese and American style management, and then used elements of transaction cost theory to explain these differences. One of his observations is that spontaneous and voluntary coordination is much more prevalent than in Western firms. Thus the need for explicit performance contracts is reduced. This is achieved by having a long period of socializing among employees—the system of lifetime employment combined with a promotion system built on seniority. A consequence is that it is critically important to have stable hierarchies with clearly defined roles, and it is difficult to inject outside expertise of a temporary nature. Thus, while Japanese firms are adept at using suppliers for standard products and services, they find it much more difficult to use high value-added services from the outside.

Englander (1984) applied the theory to the short-lived practice of inside contracting that was prevalent in the early days of the manufacturing era, especially in New England. Under this system, owners contracted with suppliers to perform all operations within a factory, while providing the productive assets such as machinery. In essence, the inside contractor agreed on a transfer price with the owner, and then had the freedom to hire workers, develop work methods, and take whatever action necessary to generate a profit.

The practice broke down for fundamental transaction cost theoretical reasons. The high asset specificity between owner and contractor (including physical, human, and site specificity) made it impossible to design contracts between owners and contractors that gave a fair share of profits to both parties. The contractor, having superior knowledge of operations, found ways to improve productivity beyond the expectation of the owner. Thus, supernormal rents accrued to the contractor. At the same time, the internal contractor did not have many proprietary skills and it was therefore relatively easy for the owner to replace the inside contractor with his own supervisor and work force. By the end of the nineteenth century the inside contracting system had given way to the vertically integrated industrial firm where all resources—human and physical—were under the control of management. One may wonder if management consulting, which has much in common with the inside contractor, will disappear in a similar way. ■

IN PART TWO, to appear in the May 1999 issue of this journal, Staffan Canback will deal with these and other implications of transaction cost theory as it relates to management consulting. He revisits the two questions: (1) why do management consultants exist; and (2) why do they organize in independent firms? and draws conclusions about the future of the industry.

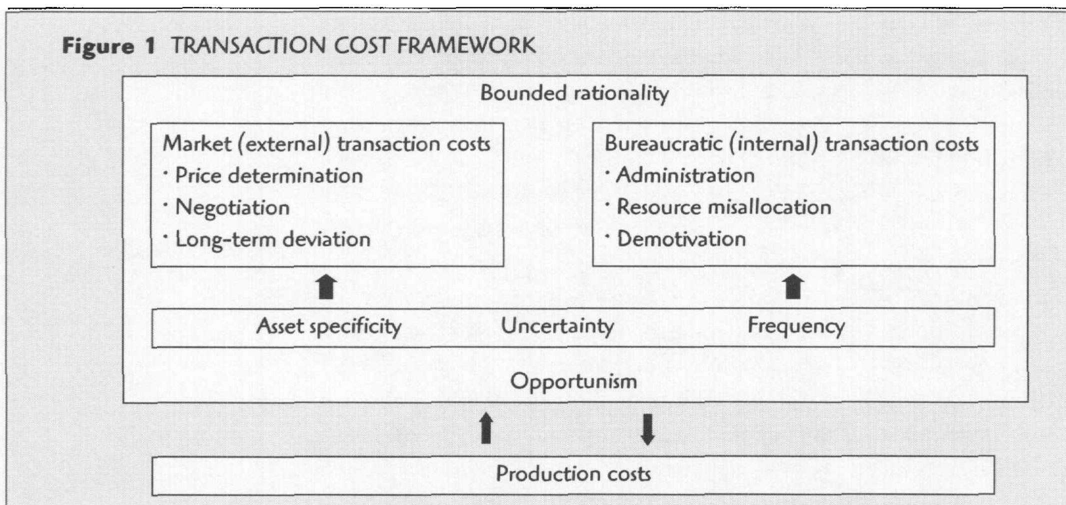

Figure 1 TRANSACTION COST FRAMEWORK

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Note

1. The numbers presented in this section are the author's reconciliation of several sources. They are broadly in line with those of most observers.

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