TRANSACTION COST THEORY AND MANAGEMENT CONSULTING

WHY DO MANAGEMENT CONSULTANTS EXIST?

Working paper

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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 market place. 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?

By using transaction cost theory as its intellectual foundation, the paper answers two questions: 1) why do management consultants exist; and 2) why do they organise in independent firms?

1. BACKGROUND

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 20 years cannot be easily explained. As one "Bernie Ramsbottom" put it in the *Financial Times* (April 11, 1981):

> 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.

1.1 SCOPE AND GROWTH OF MANAGEMENT CONSULTING

For the purposes of this paper, we will define management consultants as those who provide general management advice within a strategic, organisational or operational context, and who are institutionally organised in firms. It excludes other types of consulting such as human resource, information technology, and actuarial consulting which have little in common with management consulting except for the project nature of work. It also excludes management consultants who are not institutionally organised. 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): "management consulting is an advisory service contracted for and provided to organisations by specially trained and qualified persons who assist, in an objective and independent manner, the client organisation to identify management problems, analyse such problems, recommend solutions to these problems, and help, when requested, in the implementation of solutions."

There are a few key words in this definition. *Advisory service* indicates that the 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 we will see, these characteristics sometimes contribute to the demand for external consulting services, and sometimes detract from it.

Within the context of the definition above, management consulting has a long history (e.g. 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 institutional 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 divisionalised organisation, merit-based compensation schemes, and forecasting techniques.

During the early post-war years and in many cases growing out of war-time experience, consulting experienced a big surge, with 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 Arthur D. Little, Inc. to start the Boston Consulting Group in 1963 and more or less single-handedly operationalised 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.

Also starting in the 1960s with the emergence of Cambridge Research Institute and Management Analysis Center (today, both history), firms institutionalising the combined consulting practices of leading academics and practitioners began to make their presence known.

Yet as late as 1980, despite a growing proliferation of consulting specialities, management consulting was still an industry in its infancy with perhaps around 18,000 practising management consultants world-wide, and only around thirty to forty percent of these employed in the large, institutionally organised 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 U.S. and world-wide perhaps $2 billion.

Over the next 17 years, the management consulting industry grew to around $35 billion globally. The annual growth rate has been more than 20 percent. Today, there are approximately 140,000 consultants world-wide (a considerable fraction of this more recent growth and people count 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 30. 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 17 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 labour and the balance of power between consultants and clients.

1.2 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

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

over the last 50 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, this must 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 is because the management consulting firms are highly secretive, and thus difficult to analyse and understand.

A few facts and observations do speak for themselves. Management consultants 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 since 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 manufacturing or services.

Another aspect is that today there are approximately 70,000 management consultants in the United States, while there are 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 consultants who advise, full time. In 1980, this ratio was approximately

0.1. Clearly, and without inferring any judgement 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 fields 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, re-engineering in its various incarnations.

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 is, why is this happening on a massive scale now, and not 60 years ago? Why is it happening in the United States but only to a limited extent in Japan?

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

1.3 MANAGEMENT CONSULTANTS' ROLES AND TASKS

Schein (1988) categorises management consultants with respect to the role they play in their interaction with clients. He distinguishes between three models of consultation: 1) purchase of expertise; 2) doctor-patient, and 3) 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 emphasises his or her diagnostic capability by carefully analysing the client organisation's problems. Using the consultant's often unique experience base and diagnostic skill, the consultant quickly assesses strategic and organisational 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. The "mental adventurer" analyses truly intransigent problems such as long term scenarios for country development, by applying rigorous economic methods and leveraging his or her experience base. 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. The "management physician" derives their recommendations from a deep understanding of the internal dynamics of the client organisation, often willingly sacrificing some objectivity to gain a realistic perspective on what is achievable. The "system architect" impacts his or her clients by helping redesign processes, routines, and systems—always in close co-operation with the client. Finally, 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 thinker 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 organised 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 which goes beyond a contractually specified arms-length relationship.

Turner (1982) uses a hierarchy of tasks to demonstrate the extent of a consultant's involvement with a client. He argues that up 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

6. Building a consensus and commitment around corrective action

7. Facilitating client learning

8. Permanently improving organisational 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 a management consultants' relationship with their client is becoming increasingly complicated, and that it relies 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 the consultants. Thus, it is unclear how far down the task hierarchy management consultants have really moved.

1.4 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 since large companies have encountered most classes of problems. 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 specialised institutional environment which takes into account that the key resource is the body of consultants, a highly mobile resource, and that a consulting environment is characterised 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 to augment the internal resources. As was quantified earlier in the 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 above summary of the literature points at 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 characterised by a high degree of mutual trust.

- Management consultants are best organised in independent, specialised firms with unique characteristics and success factors (as argued by Bower and Henderson).

2. 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 market place. His ideas were neglected for many years, but around 1970 several scholars started expanding on Coase's ideas. Most notable of these is Oliver E. Williamson, who over the last 25 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 are usefully 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 organising economic activity. They thus vary with organisational form (Masten 1982). Or as Kenneth Arrow (1983) put 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).

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 organisation?" and "Why isn't all production carried out by one big firm?" His answer was that there are transaction costs which 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 limit to the size of the firm . . . [is reached] when the costs of organising 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 organisations). In any given industry the relative magnitude of market and internal transaction costs will determine what is done where.

Williamson (e.g. 1975; 1985) extended the argument by noting that two behavioural assumptions are critical. First, individuals in an organisation 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 organisations (Williamson 1993) and it is a well established tenet of Darwinian zoology (Dawkins 1989). The implication is that promises

of responsible behaviour are only credible when they are supported by enforceable commitments, since individuals otherwise would break an agreement if it is in their self-interest.

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 which have a specific usage and cannot easily be transferred to another use. Under this condition, opportunistic behaviour 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 where each party may try to “cheat” and where complicated safeguards have to be incorporated in the contract. On the other hand, if the customer owns the equipment itself, then

the incentive to cheat disappears and the cost of creating safeguard contracts is eliminated since the asset is owned by the same company.

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

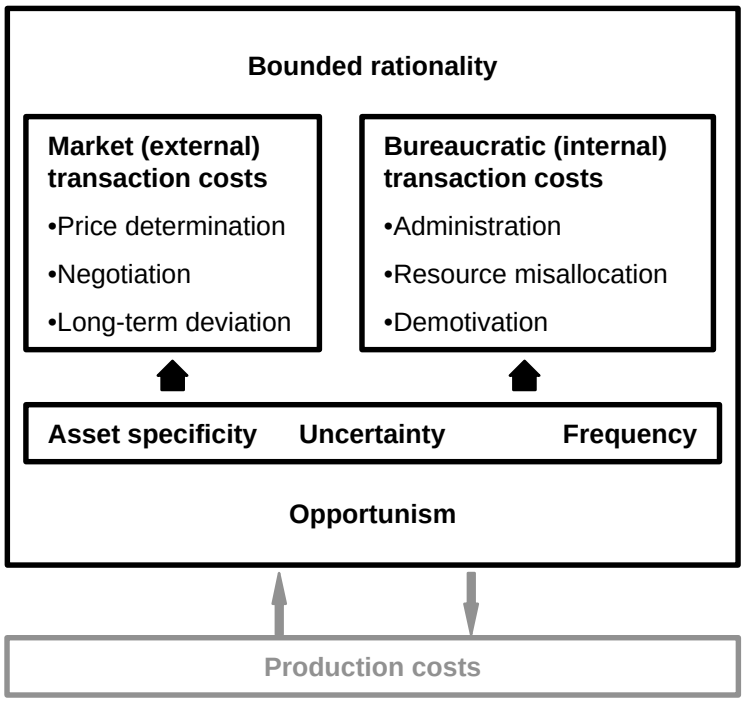
Empirical research has shown that the three factors above indeed do have an impact on the choice of transaction mechanism. For example, Masten (1984) demonstrated this within the aerospace industry, Teece (1981) and Klier (1993) in the automotive industry.

The final important aspect of transaction cost theory pertinent to this paper restates an argument from the beginning of this section. Transaction costs alone do not explain 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 minimise total cost, not only transaction costs (e.g. North 1987; 1991; 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 minimised because the resultant improvement in production costs can outweigh the increase in transaction costs.

We can now summarise transaction costs economics in the following framework:

TRANSACTION COST FRAMEWORK



Finally, two specific applications of transaction cost theory will be used later in the paper.

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 co-ordination 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 socialising between employees—the system of life-time 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 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 which 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 (both physical, human, and site specificity) made it impossible to design contracts between owners and contractors which 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 workforce. By the end of the 19th 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.

A theory is only useful when it can explain certain phenomena or predict what the next likely developments will be. In this case, we believe that transaction theory can both help to explain the very existence of the consulting industry and help to predict how it might develop in the future.

3. EXPLANATIONS

Why do management consultants exist? Drucker (1979) notes that “the management consultant is an extraordinary and indeed truly unique phenomenon.” He then argues that there are two reasons why management consultants exist. First, management is neither a science nor an art, it is a practice learned through exposure to and experience with a wide variety of companies in a wide variety of industries. A typical executive, however, lacks that exposure: As Drucker notes: “He works with the same organisation—or at the most, with very few. He lacks exposure and cannot gain it. Nor can he simulate it.” Consultants, on the other hand, transcend organisations and thus gain exposure. Second, Drucker notes that executives yearn for objective insights into their management problems. Empirical research by Gattiker and Larwood (1985) confirms that clients look for stimulation, expertise, and objectivity when they turn to outside consultants. Both these explanations for why management consultants exist suffer from not being anchored in an underlying theory. Transaction cost theory can provide a rigorous and consistent explanation for the existence of management consulting. To understand the growth of management consulting within a transaction cost economics context, three fundamental questions need to be answered:

- Why is there demand for the types of services management consultants provide?

- Why is this demand best filled by external consultants who are not direct employees of the firm—but rather contracted outsiders?

- Why are many consultants organised in specialised firms and not as employees in, say, professional services conglomerates?

These questions are addressed below. Transaction cost theory is then used to make predictions about the future evolution of the industry.

3.1 DEMAND FOR MANAGEMENT CONSULTING SERVICES

Earlier in the paper, Greiner and Metzger (1983) defined what management consultants do—they help solve management problems by giving objective and independent advice. Why is there such extraordinary demand for these types of services today, while the demand was much lower 50 years ago?

An answer is provided by Wallis and North (1986) who studied the changes in the US economy between 1870 and 1970 by dividing the gross national product into production cost and transaction cost components. They further divided transaction costs into market transaction costs (i.e. the costs of buying and selling in the market place) and bureaucratic transaction costs (i.e. the costs of co-ordinating activities within firms), along the lines suggested in the transaction cost framework in the previous chapter.

While national accounts and census data do not easily conform to this breakdown, Wallis and North nevertheless managed to show that transaction costs have become an increasingly important part of the US economy. Their estimate is that transaction costs have increased from 8 percent to 45 percent of the economy between 1870 and 1970, with the highest growth in bureaucratic transaction costs. This transformation of the economy is by no means obvious, and there has been considerable criticism of their classification methods and definitions. Still, the substantial increase in transaction costs seems to be (at least directionally) correct.

As evidence consider how the following underlying mechanisms might operate. As companies strive to reduce production costs by exploiting scale and scope economies they need to increase specialization, which in turn leads to a need for internal co-ordination. If transaction costs did not exist, then the largest company would also be the most profitable company in each market, since co-ordination between functions could be achieved without effort. But with transaction costs, this does not happen. Instead, large companies need to deploy considerable resources to realise the production scale and scope economies. On balance, this pays off and total productivity increases year after year. Reductions in production costs are larger than the additional bureaucratic transaction costs incurred, and value added grows.

As a result, traditional blue collar jobs are disappearing as production costs are reduced, while the number of white collar jobs aimed at co-ordination are increasing. Moreover, more effort is spent on creating the appropriate contractual mechanisms inside and between firms—witness, for example, the increased use of non-traditional forms of co-operation with other firms through different types of alliances.

Another change is that senior managers today deal primarily with abstract issues relating to transaction costs, while 50 or 100 years ago management was concrete and aimed at production cost reduction. Even today, many managers are puzzled by the need for abstraction and often voice the opinion that good management has to be concrete and practical.

Thus, the role of top management in a large company has changed beyond recognition. One of the most famous books by a chief executive, Alfred P. Sloan, Jr.'s ([1963] 1990) description of General Motors under his stewardship, illustrates the point. The book deals almost exclusively with production cost issues in sales, manufacturing, development, and finance, and has an insignificant amount of abstraction. For example, most of the excerpts from executive committee meeting minutes deal with practical issues such as forecasting and inventory build-up, production schedules, project development issues, cash management, etcetera. Other illustrations can be

found in old corporate annual reports. In Asea's[2] annual report of 1948 the opening statement concerns factory utilisation. The report then continues to discuss manufacturing and product development issues, while it totally ignores what we today call strategic and organisational issues.

Today's executives must still manage production costs, but an even larger challenge lies in optimising transaction costs. As Herbert Simon (1976) anticipated: "In the post-industrial society, the central problem is not how to organise production efficiently (although this will always remain an important consideration), but how to organise to make decisions—that is, to process information." The level of abstraction has increased commensurately. Today we talk about vision, strategic intent, learning organisations, and virtual corporations. We find that most companies' value can not be calculated by studying the income statement and balance sheet alone, since most of the value is embedded in abstractions such as brand image and intellectual capital.

In this world, it is necessary to be good at symbol manipulation (Reich 1991): "Symbolic analysts solve, identify, and broker problems by manipulating symbols. They simplify reality into abstract images that can be rearranged, juggled, experimented with, communicated to other specialists, and then, eventually, transformed back into reality." The symbols are often qualitative

[2] Today part of Asea Brown Boveri, the Swedish-Swiss electrical engineering conglomerate.

rather than quantitative. Examples are the five forces framework and value chain popularised by Michael E. Porter and the 7-S framework developed by McKinsey & Company. Reich estimates that in 1990 close to 20 percent of American jobs were for symbolic analysts while no more than 8 percent of workers could be classified as symbolic analysts at mid-century. Thus, as the transaction cost part of the economy has grown, so has the demand for symbol manipulation.

The earlier transaction cost framework can also be used to more specifically deduce the nature of this demand.

First, bureaucratic transaction costs stem principally from the cost of administration, the costs of resource misallocation, and the negative impact of demotivation in large organisations. Management techniques aimed at minimising these can, for example, be found within the fields of organisational design, strategic planning, and governance. Organisational design influences the cost of administration and the level of motivation significantly. An example is the superior performance of multidivisional organisations over functional organisations (Armour and Teece 1978). Strategic planning reduces resource misallocation by channelling scarce resources into areas where the company has a competitive advantage. The choice of governance models help improve motivation through incentives,

and reduces organisational slack such as excessive bureaucracy. These are exactly the kinds of services management consultants provide.

Second, market transaction costs derive from the cost of price determination, the contract negotiation costs, and the risk that there will be long-term deviations from the contract since all aspects of the future can not be anticipated. To reduce these costs in dealing with customers, suppliers, and partners, managers need information more than anything else. As a consequence, the demand for market and competitive information and the intelligent synthesis of this information has increased dramatically over the last 30 years. Once again, management consultants offer exactly such services.

In sum, the increase in demand for management consulting services is explained by fundamental shifts in the economy. Today's complex business environment requires large transaction costs to function. This in turn leads to an increasing demand for symbolic analysts—the kinds of professionals found in management consulting firms.

3.2 REASONS FOR USING EXTERNAL MANAGEMENT CONSULTANTS

Why then is the demand for symbol manipulation to a significant part satisfied by external management consultants? After all, corporate executives can do the symbol manipulation themselves, or they could use inside

consultants. Instead they often use external resources. As a result management consulting as a field has grown on average 20 percent per year.

It has not always been that way, however. Once upon a time, the executives did the work themselves Chandler (1962) describes how executives at the du Pont Company struggled with how to organise the company between 1917 and 1921. No consultants were involved. Similarly, when General Motors faced a major crisis in 1920, it turned to one of its senior executives, Alfred P. Sloan, Jr., to diagnose and solve the problem. Sloan's write-up, the *Organisation Study*, soon catapulted him into the chairmanship of General Motors—without the help of consultants. Over time, though, the do-it-yourself approach has decreased in importance because it is inefficient. Since a senior executive most likely is not familiar with the particular problem solving techniques required, the production cost is prohibitively high. This is increasingly important as management becomes more complex, while executives remain boundedly rational (Simon 1976). As with manufacturing costs, the way to reduce the production cost of symbol manipulation is to specialise, even though it leads to increased transaction costs since significant co-ordination through negotiations and transfer of knowledge is required. On balance, the gain in the quality and speed of decision making offsets the increased burden of co-ordination.

Thus, the choice for the executive is whether they should turn to internal or external specialists. According to transaction cost theory, this choice necessarily hinges on the degree of asset specificity, uncertainty, and frequency of transactions involved. If these factors are low, then buying the services in the external market will be the better solution (Rubin 1990): “When a competitive market exists, this usually offers the most powerful method of controlling costs. If a product is made internally, then the firm must spend substantial managerial resources monitoring costs and efficiencies…The first presumption should always be for purchasing inputs on the market.”

What then, can be said about the degree of asset specificity, uncertainty, and frequency of transactions in management consulting services? The two latter categories have worked in favour of using outsiders, although their influence probably is weak (as discussed in chapter 2). Volume uncertainty has decreased over the last 50 years, as evidenced by the decline in standard deviation in the S&P 500 index and in GDP growth. The frequency of transactions is usually low, with most projects being one-off initiatives.

Asset specificity, which can be broken down into physical asset specificity, human asset specificity, site specificity, and dedicated assets, is the most important factor. Giving consulting advice does not usually require an investment in physical assets that are specific to the client, and when it does (such as the purchase of client-specific software), the cost is usually billed

directly to the client. Site specificity is low since permanent co-location of people or other assets is not required. Dedicated assets that cannot be re-deployed are uncommon. The only aspect of asset specificity that truly affects the decision of using inside or outside advice is human asset specificity, i.e. to what extent is the knowledge of the consultant specific to the client.

High human asset specificity exists if the consultants need to invest significant time and effort to understand the client's business or conversely, if the client needs to invest in understanding how the consultants work. In Turner's (1982) eight task categories described in section 1.3, there is an increasing degree of human asset specificity the further down the list the consultant works. *Task 1: Providing information to a client* usually does not require significant client-specific investment, while *Task 8: Permanently improving organisational effectiveness* demands that the consultants have a thorough understanding of the idiosyncrasies of the client organisation—an understanding that often takes at least a year to build[3].

If human asset specificity is high, then there is significant risk that the client or the outside consultant will opportunistically try to take advantage of the other party, a so-called hold-up situation. For example, the client may try to reduce price or ask for free additional work since it knows that the consulting firm cannot easily reassign people who have invested in building an

understanding of the client organisation. Similarly, the consultants know that it will take time for the client to find, evaluate, and build the knowledge of a new consultant. In the end, it may be easier for the client to use internal resources rather than to go through a painful negotiation.

Thus, all other things equal, external consultants can be expected to work on issues that have low human asset specificity, while internal experts deal with issues close to the heart of the organisation. Indeed, this is the way symbol manipulation was done up till the 1970s, with fast-growing internal staffs (such as those at General Electric) addressing core issues, and external consultants working primarily on projects with low human asset specificity.

All other things are not equal though. External consultants have been able to use three other transaction cost-related factors to their advantage, while they have tried to minimise the negative impact of high human asset specificity.

First, transaction cost theory holds that opportunistic behaviour can be expected within and between firms. This opportunism becomes stronger as specialization increases to achieve scale in production, since specialization leads to goal conflicts between organisational units and individuals. Thus the risk of efficiency losses due to misaligned goals has increased with the growth

[3] It does not matter that the consultants are paid for making this investment through on-going projects with less human asset specificity. This is a sunk cost when new projects are decided on.

of transaction costs. To offset this, executives more than ever need objective, detached, advice.

Who then can best provide the objectivity? External management consultants have the benefit of not being members of the organisation They usually do not have vested interests or oblique loyalties. (The counter-argument is that the consultant has one unique sponsor to whom he or she will yield if necessary. Research (Gattiker and Larwood 1985), however, shows that this does not happen often enough to warrant concern.)

In addition to giving impartial advice on key issues, consultants can also perform managerial audits. Traditionally, this was within the domain of accountants, but as the complexity of organisations increased the ability of accountants to detect shirking decreased (Rubin 1990). External management consultants now have to a large extent filled this void since they deal with managerial issues rather than accounting issues and are equally impartial. In transaction cost terms, the external management consultant is more likely than an internal counterpart to lessen the bureaucratic insularity of top management, and to reduce internal transaction costs due to misallocation of resources within and between functions.

Second, for those activities that do not carry high human asset specificity vis-à-vis the client, the external consultants can build experience more effectively

than inside consultants. Since they work in organisations that essentially are specialised by competence, they will have seen similar problems before. The transaction cost of leveraging this knowledge base will be low. In contrast, the specialization of internal consultants is lies within their own organisation.

Also, the external consultant has the opportunity to engage in joint problem solving with colleagues (Paroush 1985). Such joint problem solving is encouraged by the incentive structure of the consulting firm. Replicating this incentive system within the client organisation is expensive and the lower quality of the incentives would therefore most likely require an administrative solution.

Third, the external consulting firm most likely has higher productivity than the internal counterpart at a client organisation. The main reason is that incentives are more easily tailored to the needs and performance of individuals in smaller organisations, while employees in larger organisations suffer from bureaucratically induced demotivation (and most consulting firms are smaller than the their clients). Moreover, the client company often does not have the freedom to provide high-powered incentives such as partnerships because of internal equity considerations. A parallel is found in R&D where smaller companies have 3-10 times higher productivity than larger companies (Cooper 1964; Zenger 1994).

The three factors above explain additional advantages held by the outside consultants relative to inside consultants. In addition, consulting firms often manage to offset the negative impact of high human asset specificity through contractual mechanisms. It is in the interest of the external consultant to minimise the cost of price determination, negotiation, and the impact of long-term deviations from the specified contract according to the transaction cost framework. Price determination is simplified since consulting firms mostly follow the practice of either charging a fixed monthly fee, especially for symbol manipulation advice such as strategy development. Negotiations are possibly burdensome, but are alleviated by the management consultant's propensity to use short and highly standardised proposals. The risk of long-term deviations from the contract (or agreement) is often small since most efforts are short in nature. Symbol manipulation seldom takes more than one year. The management consultants further reduce the risk by providing easy exits for the client, such as agreements that the work can be terminated without advance notice and without a stated reason. What is sometimes viewed as less than rigorous contracting policy is in fact a sophisticated way for the consultant to reduce the threshold for the client to buy the services.

Another question asked initially was why we see an explosion of management consulting in the United States, but not in Japan. The answer is more complicated than saying that it is a matter of being at different stages in the management skill development cycle, although it certainly is part of the

answer. The Japanese management tradition places so much importance on long-term predictability of careers and a commensurate need to carry organisational knowledge within organisations, that it is difficult for outsiders to be accepted by large corporations. The disruptive effects on the bureaucratic processes outweigh the benefits of expertise, objectivity, and alignment.

3.3 BENEFITS OF ORGANIZING IN SPECIALIZED FIRMS

The final question posed, and the last question we will address, was why management consultants are organised in specialised firms. Management consultants could ostensibly work independently in one-person firms and cooperate only when necessary. On the other hand, management consultants could form units within larger services or manufacturing corporations. In fact, both of these organisational solutions exist, but the self-contained management consulting firm is still the dominant employment mode for symbol manipulators.

There are four important reasons for management consultants to work in firms and not as individuals, even though the proprietorship usually is the most efficient governance model for small-scale activities (which management consulting arguably is) (Fama and Jensen 1983). First, the quality of advice usually increases as the number of consultants involved increases (Paroush

1985). It is in the interest of a client to have co-operation among its consultants so that individual skills are leveraged efficiently. If each consultant was self-employed then they would have to negotiate contracts each time they chose to cooperate. The contracts would at least need to specify the amount of time each consultant put in, the type of effort required, and how to handle unforeseen events. The cost of these negotiations would be prohibitively high, especially since the consulting process is characterised by time pressure and uncertainty. Consequently, bureaucratic, rather than market-based co-ordination, is more efficient.

Second, organising in firms reduces the personal risk for each individual consultant. As a member of a firm, the consultant's income is not solely determined by his or her short term success. Consequently, income will fluctuate less. Also the risk of skill obsolescence is reduced. Management consultants, like other professionals, specialise in one way or another to increase their productivity. The future value of this specialization is uncertain, however, and can change as a result of unpredictable forces (Rubin 1990). A specialist in strategic due diligence work for private equity funds may for example find that the leveraged buyout market disappears in a matter of months. Such a specialist can more easily find related work if he or she is a member of firm. The transaction cost of transitioning is reduced.

Third, a firm can more effectively establish a reputation in the market than can individuals. Management consultants sell a credence good, i.e. a service whose quality and usefulness is difficult to measure even after it has been delivered. This creates a strong incentive for the management consultant to oversell, something clients usually are well aware of. Returning to the transaction cost framework, a reputation for defining project scope appropriately will reduce both the cost of price determination for the client and lessen the need for contractual safe-guards and subsequent monitoring. Moreover, if many firms have a reputation for quality, the total market size for management consulting increases dramatically (Ackerlof 1970). The reason why individuals cannot just collaborate and establish a reputation under an umbrella brand is that the likelihood for opportunistic free-riding by individual participants is high. As a member of a firm it is easier to control and sanction such behaviour.

Fourth, organising in firms reduces the cost of learning (Leibowitz and Tollison 1978). The proprietorship has to create learning through a market-based transaction since it does not have the required skills internally. The cost of finding information and creating such networks is high since it involves multilateral contractual arrangements and the learning has high asset specificity.

In sum transaction cost theory gives us several compelling reasons why management consultants organise in firms. Why then are these firms specialised and not part of larger organisations? Two interconnected reasons explain this: 1) the internal bureaucracy costs of combining management consulting services with other activities are high, while the benefits (e.g. cross-selling) historically have been fairly low; and 2) effectively managing symbol manipulators requires highly specialised governance models—the professional partnership or corporations that emulate partnerships.

To understand the first point it is useful to return to Reich's (1991) classification of jobs. He divided the modern workplace into three categories: routine production services (repetitive tasks done over and over again such as blue-collar jobs and low- and mid-level management jobs), in-person services (simple and repetitive tasks that must be provided person-to-person such as flight attendants or retail sales workers, and symbolic-analytic services (as defined earlier). Professionals are usually symbolic analysts or routine producers. Typical "pure" symbolic analyst professionals include mergers and acquisition experts at investment banks, advertising executives, or senior executive recruiters. Routine production professionals include many systems integration consultants, auditors, and sales and trading bankers. Management consultants span this spectrum with strategy and organisational consultants arguably being close to pure symbolic analysts and operational consultants often being more of routine producers.

The symbolic analyst works in an environment characterised by quick shifts and uncertainty. Solutions are customised to the problem at hand and there is only limited re-use of ideas. The process for finding the solution is equally customised since the optimal approach is highly situation specific. Moreover, the symbolic analyst is usually a self-motivated individual with a distinct distaste for guidance. In contrast, the routine producer usually works in a more predictable environment, standardised problem solving and project management increases quality and productivity, and managerial supervision is essential.

The mechanisms for managing symbolic analysts and routine producers consequently are dissimilar. This leads to high administrative costs, resource misallocation, and demotivation, if management consultants and other professionals are managed within one firm. For example, a strategy consultant working within a systems integration firm may find that the project staffing process is too slow; an accountant employed by a strategy boutique may suffer from the lack of methodology and planning. Thus, the internal transaction cost is high and the only way around this is to separate the activities as much as possible. But why imitate the market when it is easier to operate two independent firms?

The second aspect of the specialization of management consulting firms is the choice of governance model: the use of professional partnerships or

incorporated equivalents[4]. Transaction cost theory holds that a firm should be owned by those who have a claim on the firms most specialised assets (Williamson 1985). For example, in manufacturing companies the most specialised, nonredeployable assets are usually physical assets such as plant, property, and equipment. The suppliers of capital for these assets will be the residual claimants who absorb the swings in profitability; in other words, the shareholders. Management consulting firms differ in that the most specialised asset is the human capital embedded in the most senior consultants. These senior consultants, often called partners, should be the residual claimants. It is not optimal to run management consulting firms as joint stock companies. The failure of Booz•Allen & Hamilton's and Arthur D. Little's stock market introductions testify to the importance of this rule. The separation of residual claims and specialised assets arguably led to goal conflicts and lower performance.

The professional partnership has other characteristics that makes it the governance form of choice for symbol manipulators: "In professional partnerships, a partner's share in net cash flows is renegotiated periodically, and his rights in net cash flows are often limited to his time or service in the organisation…flexible sharing rules, inalienability, and limited horizons distinguish the residual claims of professional partnerships" (Fama and Jensen 1983). These characteristics contribute to making the partnership the

[4] Firms like McKinsey & Company or Bain & Company are not true partnerships but rather

most effective governance form for management consultants since they allow for the following:

Decentralised decision making and quality control. In management consulting the most important knowledge is client specific. Only the team on the ground, led by a partner, has this knowledge and can make informed decisions about how to serve the client best. External monitoring by review boards, quality inspectors, etc. is meaningless and costly.

Flexible sharing. There is significant risk that members of a management consulting firm will free-ride on the effort of others. The professional partnership reduces this risk since the partner's share of income is not fixed, but rather renegotiated annually based on performance. Moreover, it is in the interest of all partners to monitor the performance of the consultants he or she works with to ensure equitable distribution of income.

Limited horizon. Almost all the value of a management consulting firm is capitalised in individual knowledge, which is a fairly current asset. Over time, the partner's contribution to the firm may thus decline. Thus, when a partner's knowledge capital is used up or withdrawn from the firm the partner will cease to share in the income.

* * * *

Management consulting firms exist for good reasons. The nature of management has changed towards abstract issues embodied in the transaction cost part of the economy. Thus, there is a market for symbol manipulation—a market which hardly existed 50 or 100 years ago.

External management consultants are well suited to fill this market demand. They bring objectivity, experience, and have high productivity, while the market transaction cost of working as outside suppliers to their clients often is lower than the internal transaction costs which would exist if they were part of the client organisation.

The practice of organising in firms governed as professional partnerships (or virtual partnerships) matches the most specific assets (human capital) with the residual claimants which allows for efficient control and compensation.

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incorporated joint stock companies that retain most of the characteristics of partnerships.

4. PREDICTIONS

There are two interesting development paths for the future: 1) the benefits of management consultants continue to outweigh the disadvantages and the consultants influence and involvement increases; or 2) the asset specificity is so high that clients eventually decide to reclaim the services provided by management consultants, much akin to the disappearance of the inside contracting system.

4.1 CONTINUED GROWTH SCENARIO

For the first scenario to materialise, the following conditions would have to be true. First, the current trend towards deeper involvement of management consultants in solving the core problems of their clients has to be moderated, since otherwise the asset specificity may increase so much that external sourcing of consulting services becomes unfeasible. Alternatively, the contractual arrangements are refined at a pace that exceeds the increase in asset specificity. Second, uncertainty does not increase significantly since high uncertainty on balance leads to internal sourcing. Third, clients do not make significant strides in reducing their bounded rationality and internal bureaucracy costs, since any reduction of these factors will make internal sourcing of symbolic analysts more attractive.

If this scenario develops, then we may see a radically different corporate world within 15 to 30 years. Initially, we will see continued rapid expansion of the management consulting industry. Soon there will be as many external symbol manipulators as there are executives in large companies. Over time, the balance of power will shift to the management consultants. They will possess most of the knowledge about management (together with academics). They will own the knowledge networks which will be essential in the global economy. The management consulting firms will also deplete the stock of young, well educated, and intelligent people who will form the backbone of the future economy. We will thus see a shift in the balance of influence from the traditional product and services sectors to the symbolic analyst sector, just as we saw a shift of influence from the agriculture sector to the industrial sector in the 1800s.

Ultimately, the management consulting firms will move from being advisers, to taking over the management function of their clients. We will thus see a new corporate configuration where the consultants work as the symbolic manipulators of corporations, and the old corporate structures are dismantled to provide the building blocks for the manipulative activities. The consultants will manage high value added networks of product design and delivery capability where they provide the strategic and integrative capabilities. The old corporations will provide low value-added products, subassemblies, and services to the specification of the network operators (the consultants).

4.2 DECLINE SCENARIO

Under the second scenario, management consulting is doomed. For this scenario to occur, a combination of the following forces need to develop. First, the asset specificity of advice needs to be high so that clients find it difficult to handle the interface between clients and consultants and consequently decide to internalise symbol manipulation. Second, clients develop their management practices to accommodate the needs of many types of employees (routine workers, in-person service providers, and symbolic analysts), and of multiple residual claimants (both capital providers and senior executives). Third, uncertainty increases to a significantly higher level than today. Fourth, the types of problems handled by management consultants become more prevalent, so that it makes sense for the clients to internalise the required skills.

If this happens, we might see a second version of the demise of inside contracting. Clients will initially hire away top talent from consulting firms to do the same job with the same compensation. The alignment of high asset specificity with internal sourcing will over time prove more cost effective than buying consulting services from the outside. The knowledge accumulation then shifts to the clients, and management consulting firms find it increasingly difficult to provide high value added advice. However, since management consultants also serve as an audit function and they provide impartial advice, they will not disappear entirely. But the nature of the work

may shift from Schein's expert and doctor-patient models to the process consultation model. With this model predominating, it may not be as important to organise management consultants in firms, and the size of the average consulting firm may shrink.

In reality, neither of these scenarios may evolve. Rather, both scenarios can co-exist and apply more in certain market segments than in others. However, nothing prohibits the full scale development along one of these scenarios. The evolution of the industry may still hold many surprises, but one thing is for sure given the incredible changes going on in today's economy there will always be a need for symbol manipulators. The only question is whether they will reside within or outside the firm.

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After outlining the relationships between transaction cost economics, signaling theory, embeddedness theory and sociological neoinstitutionalism, Thomas ArmbrÃ¼ster applies these theories to central questions such as: Why does the consulting sector exist and grow? Which institutions connect supply and demand?Â Review of the hardback:'The Economics and Sociology of Management Consulting is a landmark publication. Professor ArmbrÃ¼ster's book is a superb analysis of the consulting sector, convincingly demonstrating why it has grown so large, the dynamics of competition between firms, and the nature of relationships between clients and consultants. How transaction cost influence the choice of governance model? Transaction cost: approaches to definition. Approach proposed by Ronald Coase. â€¢ Starting question: WHY firms? â€¢Â â€¢ Nobel Prize (1996): William Spencer Vickrey and James Mirrlees for their research into the economic theory of incentives under asymmetric information. Contract-making cost. â€¢ Lawyer costs â€¢ Taxes as transaction goods. Transaction cost logic has broad applicability to empirically researchable issues of concern to finance scholars, and the work mentioned here suggests strong and growing support for transaction cost predictions. 4.1.5. Organization Theory An area in which transaction cost economics makes an important contribution and has. had considerable empirical influence is organization theory.Â We identify more than 30 articles that explicitly bring together and test insights from organization theory and transaction cost economics, while many other empirical papers that are not included in our review have important implications for, or are in the spirit of, TCE theory.32 These TCE-oriented approaches examine a broad range of issues and relate to a number of different perspectives.