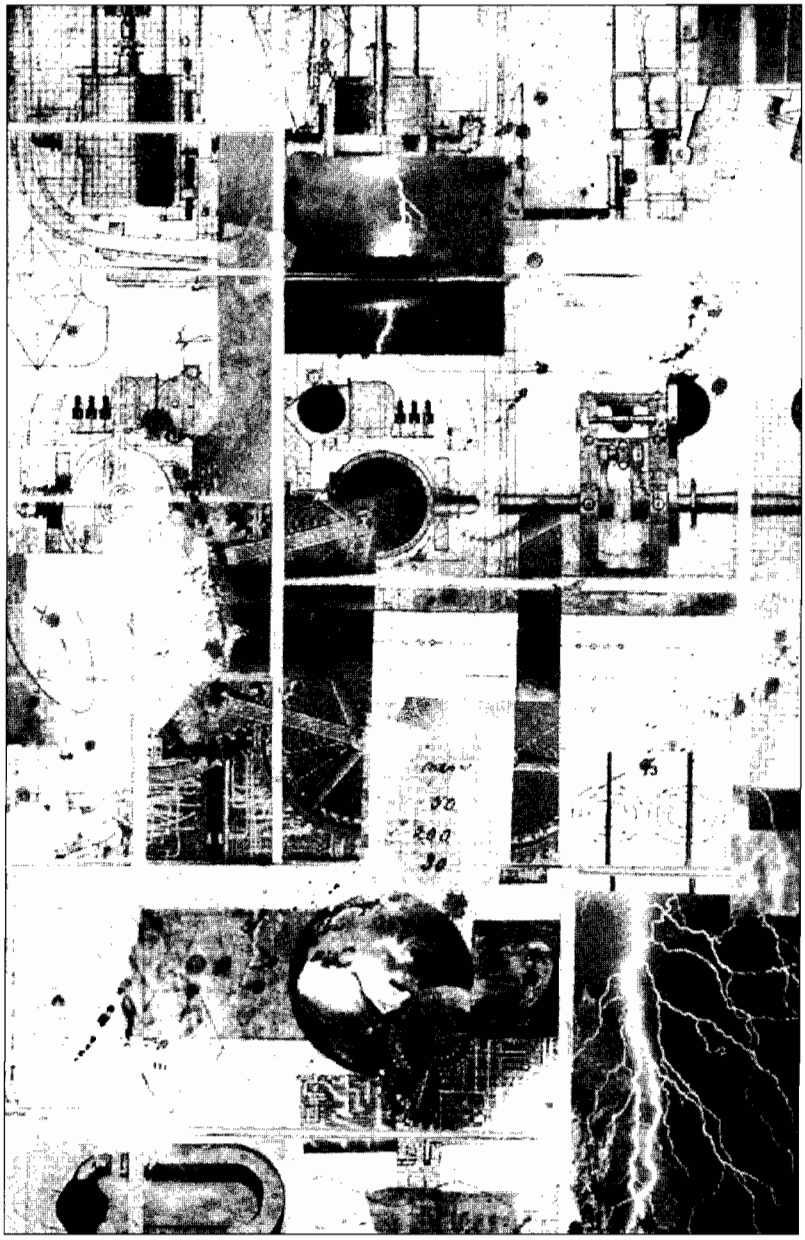
Canback, Staffan. 1999. The Logic of Management Consulting, Part 2. *Journal of Management Consulting* 10 (3): 3-12

Journal of MANAGEMENT CONSULTING

The Forum for Management Consultants Worldwide



The Logic of Management Consulting

(Part Two)

Staffan Canback

Reprinted from Volume 10, No. 3 - May 1999

The Logic of Management Consulting

(Part Two)

STAFFAN CANBACK

EDITOR'S NOTE:

In this second of a two-article series, Staffan Canback, a consultant at Monitor Company, draws upon the history of management consulting and the explanation of transaction costs detailed in the first article to present a unique rationale explaining the unprecedented demand for consulting services. Canback then develops scenarios for the industry's future evolution, ending with a perspective on the future of management consulting.

Consultants and clients alike often ask why the management consulting industry has grown so fast over the past twenty years. Graduating students similarly ask if the growth can be sustained and if career opportunities in the industry will continue to be excellent. Skeptics, such as O'Shea and Madigan (1997), argue that management consultants often do not add real value to their clients and that the industry is a fad, albeit a fad with longevity. Proponents argue that we live in a free and open economy, and if clients did not derive value from consulting services, then they would stop using them.

Transaction cost theory helps us understand that there are fundamental reasons why management consultants exist and that the industry is more than a fad. The theory also helps make predictions about the future. Under what circumstances will the industry continue to grow? Is it possible—or advisable—for clients to recapture some of the activities that are now performed by consultants? These issues are discussed in this article, ending with the perspective that the industry will continue to grow and that external management consultants will continue to increase their "problem-solving market share.

Why Do Management Consultants Exist?

Drucker (1979) argues that "the management consultant is an extraordinary and indeed truly unique phenomenon." He argues that there are two reasons why they 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 organization—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 organizations and thus gain exposure. Second, Drucker observes that executives yearn for objective insights into their management problems. Empirical research by Gattiker and Larwood (1985) confirms that clients first and foremost look for stimulation, expertise, and objectivity when they turn to outside consultants. Both these explanations for why management consultants exist are compelling, but they suffer from not being anchored

■ *Will consulting soon be headed for decline and decay? Or, is expansion even beyond current realms in the cards?*

■ *La profession de consultant va-t-elle tomber dans le déclin et la décrépitude ? Ou son expansion va-t-elle se déployer au-delà des domaines anticipés ?*

■ *Geht es mit Beratungsdiensten schon bald bergab? Oder ist Expansion, gar über den derzeitigen Grad hinaus, machbar?*

in an underlying theory. Transaction cost theory provides a rigorous and consistent explanation for the existence of management consulting. To understand the growth of management consulting within a transaction cost economics context, two fundamental questions need to be answered:

- Why is there increasing 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?

Demand for Management Consulting Services

In Part One, 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 compared to fifty years ago?

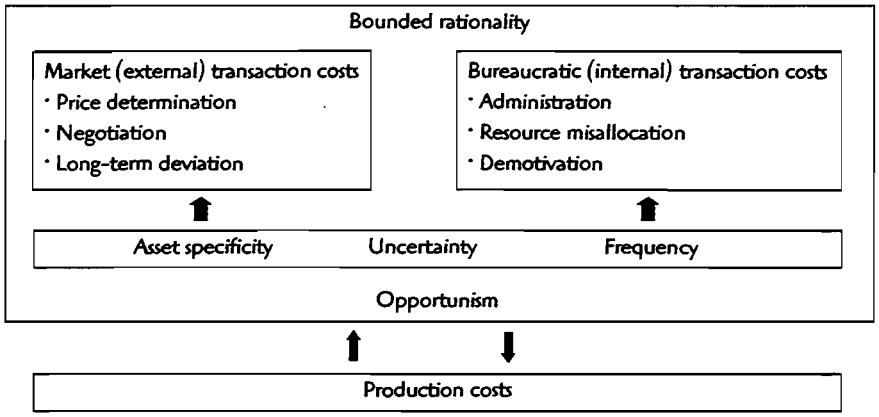
An answer is provided by Wallis and North (1986) who studied changes in the U.S. economy between 1870 and 1970 by dividing the gross national product into production cost and transaction cost components. They further divided transaction costs into market transaction costs (such as the costs of buying and selling in the marketplace) and bureaucratic transaction costs (such as the costs of coordinating activities within firms) along the lines suggested in the transaction cost framework shown in Figure 1.

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 U.S. economy. They estimate that transaction costs increased from 8 to 45 percent of the economy between 1870 and 1970, with the highest growth occurring in bureaucratic (internal) transaction costs. Applying the same methodology to the subsequent years to date, I found a continued increase in transaction costs.

Traditional blue-collar jobs are disappearing as production costs are reduced, while the number of white-collar jobs aimed at coordination is increasing.

To understand this trend, consider how the following underlying mechanism might operate. As companies strive to reduce production costs by exploiting scale and scope economies, they must specialize—which in turn leads to a need for internal coordination. If transaction costs did not exist, then the largest company in each market would also be the most profitable company, since coordination between functions could be achieved without effort. But because of transaction costs, this does not happen. Instead, large companies must deploy considerable coordination resources in order to realize production scale and scope economies. On balance, this pays off, and total productivity increases

Figure 1 TRANSACTION COST FRAMEWORK



year after year. Reductions in production costs are larger than the additional bureaucratic transaction costs incurred, and therefore value added grows.

Thus, traditional blue-collar jobs are disappearing as production costs are reduced, while the number of white-collar jobs aimed at coordination is increasing. Moreover, more effort is spent on creating the appropriate contractual mechanisms inside and between firms. Witness, for example, the increased use of nontraditional forms of cooperation between firms through different forms of alliances and partnerships.

As a consequence, senior executives today deal primarily with abstract issues relating to transaction costs, while fifty or a hundred years ago they had more concrete tasks aimed at reducing production costs. Thereby, the role of top management in a large company has changed beyond recognition. In 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. 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, and cash management. Other illustrations can be found in old corporate annual reports. The opening statement in Asea's[1] 1948 annual report concerns factory utilization. It goes on to discuss manufacturing and product-development issues, and ignores what today we call strategic and organizational issues.

In contrast, while today's executives still must manage production costs, an even larger challenge lies in optimizing transaction costs. As Herbert Simon (1976) anticipated: "In the post-industrial society, the central problem is not how to organize production efficiently (although this will always remain an important consideration), but how to organize to make decisions, that is, to process information." The level of abstraction has increased commensurately. Today we talk about vision, strategic intent, learning organizations, and virtual corporations. We find that most companies' value can not be calculated by studying the income statement and balance sheet alone, since much of the market 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 rather than quantitative. Examples are the five forces framework and the value chain developed by Michael E. Porter, and the 7-S framework designed by McKinsey & Company. Reich estimates that in 1990 close to 20 percent of American jobs were held by "symbolic analysts," while at midcentury no more than 8 percent of workers could be so classified. Thus, as the transaction cost part of the economy has grown, so has the demand for symbol manipulation.

Nature of Demand

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

First, bureaucratic (internal) transaction costs principally stem from the cost of administration, the costs of resource misallocation, and the negative impact of demotivation in large organizations. Management techniques aimed at minimizing these can, for example, be found within the fields of organizational design, strategic planning, and governance. Organizational design influences the cost of administration and the level of motivation significantly. An example is the superior performance of multidivisional organizations over functional organizations (Armour and Teece, 1978). Strategic planning reduces resource misallocation by channeling scarce resources into areas where the company has a competitive advantage. The choice of governance models help improve motivation through incentives, and reduces organizational slack such as excessive bureaucracy. These are exactly the kinds of problems management consultants solve.

STAFFAN CANBACK *is a consultant at Monitor Company, based in Cambridge, Massachusetts. Earlier, he was a partner of McKinsey & Company in Scandinavia. Mr. Canback is globally responsible for Monitor's Financial Services Practice, leads its Scandinavian activities, and oversees faculty contacts and recruiting at Harvard University. Serving companies in such industries as financial services, telecommunications, travel, and manufacturing, he assists large companies in addressing strategic, financial, and governance issues. Mr. Canback holds an MBA from Harvard Business School, an AdipC from the Henley Management College in England (where he developed the analysis leading to this two-article series), and an MSc in Electrical Engineering from the Royal Institute of Technology in Sweden.*

Second, market transaction costs derive from price determination, contract negotiation, and the risk that there will be long-term deviations from the contract due to unanticipated events. To reduce these costs, executives primarily need information. The demand for market and competitive information—and the intelligent synthesis of this information—has increased dramatically over the last thirty years. Services such as these are offered by management consultants.

In sum, the increase in demand for management consulting services is explained by fundamental shifts in the economy. Today's complex business environment requires high transaction costs in order to function. This in turn increases demand for symbolic analysts—the kinds of professionals found in modern management consulting firms. Stryker (1954) identified this trend years ago when he observed that consultants used to work on "specialized problems—in plant layout, for example, or in wage-incentive programs," but "a relatively new kind of consultant—the man or firm that in effect offers to set a company's basic objectives, policies, structure, and strategies" was emerging.

Reasons for Using External Management Consultants

Why then is the demand for symbol manipulation satisfied largely by external management consultants? After all, corporate executives could do the symbol manipulation themselves, or they could use internal consultants. Instead they often turn to outside help, causing a 20 percent annual growth in the industry since 1980. It has not always been this way. Once upon a time, executives did the work themselves. Chandler (1962) describes how executives at the du Pont Company struggled between 1917 and 1921 with how to organize the company. They created working parties and ad hoc committees, and at the same time worked individually on position papers and proposals. 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 *Organization Study* (1919), soon catapulted him into the chairmanship of General Motors—without the help of consultants.

Over time, however, the do-it-yourself approach has decreased due to it's inefficiency. Typically, a senior executive is not familiar with the particular problem he or she is facing and does not know which problem-solving technique to apply. This is increasingly true as management becomes more complex. Executives remain boundedly rational (Simon, 1976); and, of course, they do not have the capacity to learn everything.

Today's executives must still manage production costs, but an even larger challenge lies in optimizing transaction costs.

Thus, the choice for the executive often is whether to turn to internal or external experts for advice. According to transaction cost theory, this choice hinges on the degree of asset specificity, demand volatility, technological uncertainty, and the frequency of transactions involved (as explained in Part One). If these factors are insignificant, 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 factors have worked in favor of using outsiders, although their influence probably is weak. Uncertainty has decreased over the last fifty years, as evidenced by the decline in volatility of the S&P 500 index and of GDP growth. The frequency of transactions is usually low, with most problems to be solved being unique and singular.

Asset specificity stands alone as the most important factor and can be broken down into four components: physical asset specificity, human asset specificity, site specificity, and dedicated assets. 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 the consultant rarely moves permanently to the client's location. *Dedicated assets* that cannot be redeployed are uncommon. The only aspect of asset specificity that truly affects the decision to use internal or external experts is *human asset specificity*. That is, the extent to which the consultant's knowledge is specific to the client.

Human Asset Specificity

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 Part One, 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 a client-specific investment, while Task 8: *Permanently improving organizational effectiveness,* demands that the consultant have a thorough understanding of the idiosyncrasies of the client organization—an understanding that often takes at least a year to build.

If human asset specificity is high, then there is significant risk that the client or the outside consultant will try to take advantage of the other party, a so-called hold-up situation. For example, the client may try to reduce the 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 organization. Similarly, 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 avoid the hold-up situation by using internal resources rather than to go through a painful negotiation with outsiders.

Thus, all other things being 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 organization. Indeed, this is the way symbol manipulation was done until the 1970s, with fast-growing internal consulting staffs (such as those at General Electric and Xerox [Kelley, 1979]) addressing core issues, and external consultants working primarily on projects with low human asset specificity.

Rationale for External Consultants

But all other things are not equal. External consultants have been able to use three other transaction cost–related factors to their advantage, while trying to minimize the negative impact of high human asset specificity.

■ First, opportunistic behavior can be expected within and between firms. As specialization to realize scale and scope economies increases, this opportunism becomes stronger, given that specialization leads to goal conflicts between organizational units and individuals. A manager in marketing will not necessarily have the same goal as a manager in manufacturing, even though the goal of the company is to maximize shareholder returns. Thus, the risk of efficiency losses due to misaligned goals increases with the growth 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 organization. They usually do not have vested interests or oblique loyalties. (The counterargument is that the consultant has one unique sponsor to whom he or she will yield if necessary. Research [Gattiker and Larwood, 1985], however, suggests 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 has been within the domain of accountants, but as the complexity of organizations has increased, the ability of accountants to detect shirking has decreased (Rubin, 1990). External management consultants have to a large extent filled this void. In transaction cost terms, the external management consultant is more likely than an

DEFINITIONS

Transaction costs
The costs of allocating resources in an imperfect world of misunderstandings, misaligned goals, and uncertainty. *External transaction costs* center around the cost of contracting; *internal transaction costs* are dominated by the cost of coordination. Transaction costs are often described as "economic friction."

Asset specificity
The degree that a particular asset or set of assets is dedicated to a given use. In the context of this article, the degree that a consulting firm's investment in the know-how of its professional staff—its human asset specificity—is applicable to an individual client.

Uncertainty
Lack of information about the future. In particular, demand volatility and technological uncertainty are important to transaction cost theory; similar to risk.

Bounded rationality
The notion that human beings strive to be rational in making choices, but since the brain cannot process infinite amounts of information those choices are not always correct.

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, external consultants can build experience more effectively than can inside consultants. Having seen similar problems before, the cost to external consultants for leveraging this knowledge base will be low. In contrast, internal consultants are experts in how their own company works, but seldom are they in a position to create an experience base by problem type.

Also, the external consultant often has the opportunity to engage in joint problem solving with colleagues (Paroush, 1985). Such collaboration is encouraged by the incentive structure of consulting firms. Replicating this type of system within a client organization often is difficult because most client organizations are joint stock companies with very different reward systems.

■ Third, external consulting firms are likely to outproduce their internal counterparts. Incentives are more easily tailored to the needs and performance of individuals in smaller organizations, while employees in larger organizations suffer from bureaucratically induced demotivation (and most consulting firms are smaller than their clients). A parallel is found in R&D, where smaller companies have three to ten times higher productivity than larger companies (Cooper, 1964; Zenger, 1994).

The three factors just described are advantages held by external consultants relative to internal consultants. Consulting firms often manage to offset the negative impact of high human asset specificity through contractual mechanisms. In accordance with the transaction cost framework, it is in external consultants' interest to minimize the cost of price determination, negotiation, and the impact of long-term deviations from the agreed-upon contract. Price determination can be simplified by charging a fixed monthly fee, and the cost to the client is proportional to the length of the project. Negotiations are possibly burdensome, but can be alleviated by using short and standardized proposals. The risk of deviations from the intended task is usually small because most efforts are relatively brief and there is constant feedback between client and consultant. Projects seldom take more than one year, and the norm is three to nine months. Consultants further reduce this 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 a less-than-rigorous contracting policy is in fact a mechanism for consultants to offer their services more readily. The above logic can be summarized in Figure 2.

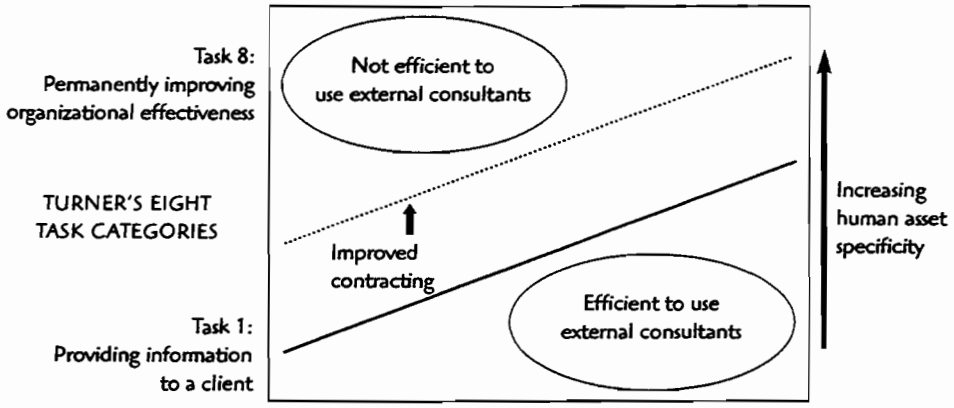
Part One posed the question of why we have seen an explosion in the demand for management consulting in the United States, but not in Japan. The answer is complicated. Part of the answer lies in Japanese and Americans being at different stages in the management-skill development cycle. More important, Japanese management tradition places so much reliance on the long-term predictability of careers and protecting organizational knowledge that it is difficult for outsiders to be accepted by large corporations. External consultants' disruptive effects on clients' management processes, so far, have outweighed the benefits of their expertise, stimulation, and objectivity.

Unlike in earlier times, abstract issues and transaction costs demand management's attention.

How Will Management Consulting Evolve?

Management consulting firms exist for good reasons. The nature of management has changed. Unlike in earlier times, abstract issues embodied in the transaction cost part of the economy demand management's attention. Consequently, there is a market for symbol manipulation—a market that barely existed fifty to a hundred years ago. External management consultants are well suited to meet this demand. They bring objectivity, experience, and high productivity. Working with outside experts often, though not always, can cost the client less

Figure 2 MANAGEMENT CONSULTANT'S DOMAIN



than using internal resources, when both direct and indirect costs are factored in. As we will see in the next section, this is likely to hold true in the future as well.

Forty-five years ago, management consulting was considered "one of the hottest—and most influential—growth industries" (Stryker, 1954). If anything, today this is even more the case. The industry may continue to grow, or it could decline. Many expect that consultants will continue to increase market share in problem solving on behalf of corporations and other organizations—and thus continue industry growth. On the other hand, it may be that clients eventually will reclaim the services provided by management consultants—especially those with high human asset specificity. This would parallel the disappearance of the inside contracting system discussed in Part One of this series. Under this scenario, the consulting industry could stagnate and decline.

Continued Growth Scenario

Remember that the key obstacle to using external resources such as management consultants—according to transaction cost theory—is the degree of human asset specificity involved, and that high uncertainty makes it difficult to use outside contractors. For the growth scenario to materialize, the following conditions will have to exist:

- The current trend toward management consultants' deeper involvement in solving clients' core problems would have to moderate. If it does not, asset specificity will increase to the point of making external sourcing of consulting services unfeasible. Alternatively, contractual arrangements between client and consultant would need refinement at a sufficient pace in order to mitigate the increasingly negative effects of asset specificity; witness, for example, the increasing use of success fees that tend to align the objectives of clients and consultants.
- The internal bureaucracy costs of client organizations would have to remain at current or higher levels. If, however, clients can reduce the costs of administration, resource misallocation, and demotivation, then transaction cost theory tells us that symbol manipulation done internally is more advantageous. Indeed, highly bureaucratic organizations tend to use more external management consultants do than lean ones. (A continued high level of internal bureaucracy costs will stimulate demand for external management consultants.)
- Uncertainty (in terms of demand volatility or technological uncertainty) could not increase significantly, given that high uncertainty reduces the benefit of buying products or services from the outside.

If the foregoing growth scenario develops more or less as outlined, within fifteen to thirty years we could see a radically different corporate world. Initially, we would see continued rapid expansion of the management consulting industry. Soon there would be as many external symbol manipulators as there are executives in large companies. Over time, the balance of power would shift to the management consultants. They would possess the most knowledge about management practice in general, and their clients' problems specifically. They would own the knowledge networks that will be essential in the global economy. The management consulting firms would also attract most of the young, intelligent, and well-educated people forming the backbone of the future economy. We thus would see a shift in the balance of influence from the traditional product and services sectors to the symbolic analyst sector—just as in the 1800s we saw a shift of influence from the agriculture sector to the industrial sector.

Ultimately, management consulting firms would move from being advisors to taking over the management function of their clients. We would see a new corporate configuration in which the consultants work as the symbol manipulators of corporations, and the old corporate structures are dismantled to provide the building blocks for those manipulative activities. Consultants would manage high value-added networks of product design and delivery activities, whereby they would provide strategic and integrative capabilities. The old corporations would provide low value-added products, subassemblies, and services to the specification of the network operators—the management consultants.

Decline Scenario

Under the second scenario, management consulting would be doomed, just as inside contracting once flourished and then declined (see Part One). How would this "doomsday" scenario come to be?

- The asset specificity of management consulting advice would need to be so high that clients would find it difficult to handle the interface between themselves and consultants and thus decide to internalize symbol manipulation.
- Large corporations would have to develop their management practices to accommodate the needs of different types of employees—both symbolic analysts and routine workers. In particular, this would require differentiated approaches to performance evaluation and the setting of incentives (a process that has already started as evidenced by the escalating compensation packages lavished on executives).
- Uncertainty would have to increase to a significantly higher level than it is today.
- The types of problems handled by management consultants would have to become more prevalent within client firms. (Remember, as an activity becomes more frequent there is a tendency to internalize it.)

Should all these things happen, we may live to see a second version of the demise of inside contracting. Clients would initially hire away top talent from consulting firms to do the same jobs as before and with the same compensation—but now as employees. The alignment of high asset specificity with internal sourcing would over time prove more cost effective than buying consulting services from the outside. Knowledge accumulation then would shift toward the clients, and management consulting firms would find it increasingly difficult to provide high value-added advice. However, since management consultants also would be providing an auditing function, and assuming they provided objective advice, they would not disappear entirely. The nature of their work, however, might well shift from Schein's expert and doctor-patient models to the process consultation model—one in which the consultant facilitates and the client provides the expertise.

Within fifteen to thirty years we could see a radically different corporate world.

Under such a decline scenario, external management consultants would work primarily on

routine assignments. Yes, they would continue to leverage industry knowledge from client to client, much as McKinsey & Company and others do today. But by its very definition, this knowledge is most unlikely to add unique value to the individual client. Furthermore, opportunities to work on core issues such as strategy and governance would be highly limited. In the end, the consulting process would become substantially streamlined and highly efficient; on the other hand, the industry no longer would be able to attract the best people. Management consulting will cease to be "one of the hottest—and most influential—growth industries."

Future Role of Management Consultants

In the end, neither of these two scenarios seem very likely to fully evolve. Nevertheless, looking to the next ten or fifteen years, several factors favor the "continued-growth scenario."

So far, the management consulting industry has been able to largely surmount the hurdle of asset specificity and thereby redefine an appropriate division of labor between clients and consultants. New forms of collaboration have made it easier for clients to outsource problem solving of core issues. An example is the tendency of consulting firms to strive for long-term relationships with clients as opposed to working on one project per client. Another example is that consultants have been backing away from the classical model of "consultants analyze and recommend; clients decide and implement." Collaboration today is much more sophisticated than it was a mere fifteen years ago, with clients and consultants now working together throughout the entire change process. This trend can be expected to continue.

Of at least equal significance—with or without reengineering and the like—there is no indication that internal (bureaucratic) transaction costs within large corporations will decline. To the contrary, as noted earlier, the transaction cost part of the economy has grown steadily since the 1870s. Nor is this trend likely to be disrupted any time in the foreseeable future. For

"I made the short list and won the engagement. He was so pleased with my fee, it was depressing."

one thing, the increasingly global economy adds to complexity. Within large corporations, the demand for coordination continues unabated. New technologies such as artificial intelligence appear unlikely within the foreseeable future to change this picture.

Finally, there is scant evidence that large corporations will be able to realign their management processes sufficiently in order to be able to internalize symbol manipulation. Stinchcombe (1965) found that the way a company manages itself to a large degree is determined by when it was founded. Most large companies, being fairly old, seem unlikely to fundamentally change their modus operandi, despite the opportunities presented by the information technology revolution.

If the above arguments hold true, the management consulting industry will continue to prosper. Consultants, together with other external advisers, will play an increasingly important role in the global economy and may ultimately take on the role of network managers. Relationships between clients and consultants will grow stronger and symbiotic. Management consulting will continue to be a preferred career choice for many graduating students at the premier business schools and universities. ■

Note

1. Asea is today part of Asea Brown Boveri (ABB), the Swedish-Swiss electrical engineering conglomerate.

References

Armour, H. O., and D. J. Teece. 1978. Organizational structure and economic performance: A test of the multidivisional hypothesis. *Bell Journal of Economics* 9, 106–122.

Chandler, A. D., Jr. 1962. *Strategy and structure: Chapters in the history of the American industrial enterprise.* Cambridge, MA: MIT Press.

Cooper, A. C. 1964. R&D is more efficient in small companies. *Harvard Business Review* 42 (May–June), 75–83.

Drucker, P. F. 1979. Why management consultants? In *The evolving science of management,* edited by Z. Melvin and R. G. Greenwood. New York: AMACOM.

Gattiker, U. E., and L. Larwood. 1985. Do clients employ management consultants? *Consultation* 4(2), 119–129.

Greiner, L., and R. Metzger. 1983. *Consulting to management.* Englewood Cliffs, NJ: Prentice-Hall.

Kelley, R. E. 1979. Should you have an internal consultant? *Harvard Business Review* 57 (Nov.–Dec.), 110–120.

O'Shea, J., and C. Madigan. 1997. Dangerous company: The consulting powerhouses and the businesses they save and ruin. New York: Random House.

Paroush, J. 1985. Notes on partnerships in the service sector. Journal of Economic Behavior and Organization 6, 79–87.

Reich, R. B. 1991. *The work of nations: Preparing ourselves for 21st-century capitalism.* New York: Knopf.

Rubin, P. H. 1990. *Managing business transactions.* New York: Free Press.

Simon, H. A. 1976. *Administrative behavior.* 3rd ed. New York: Free Press.

Sloan, A. J., Jr. 1919. *General Motors Corporation: Organization study.* Detroit, MI: General Motors.

Sloan, A. P., Jr. [1963] 1990. *My years with General Motors.* Introduction by Peter F. Drucker. New York: Currency.

Stinchcombe, A. L. 1965. Social structure and organizations. In *Handbook of organizations,* edited by J. G. March. Chicago: Rand McNally.

Stryker, P. 1954. The ambitious consultants. *Fortune* (May), 82–85.

Turner, A. N. 1982. Consulting is more than giving advice. *Harvard Business Review* 60 (Sept.–Oct.), 120–129.

Wallis, J. J., and D. C. North. 1986. Measuring the transaction sector in the American economy, 1870–1970. In *Long-term factors in American economic growth. studies in income and wealth series,* edited by S. L. Engerman and R. E. Gallman. Chicago: University of Chicago Press.

Zenger, T. R. 1994. Explaining organizational diseconomies of scale in R&D: Agency problems and the allocation of engineering talent, ideas, and effort by firm size. *Management Science* 40(6), 708–729.

INDEXED UNDER:

Transaction cost; Management consulting, economic rationale for; Future scenarios

THE LOGIC OF MANAGEMENT CONSULTING

Part Two

by

Staffan Canback

1999

Editor's note: In this the second of two articles in our series, "The Logic of Management Consulting," Staffan Canback, a consultant at Monitor Company, draws deeply on the industry background and the explanation of transaction costs detailed in the first article to present a unique rationale for the industry's existence. He then develops scenarios for the industry's evolution, ending with a perspective on the future of management consulting. A future characterized by continued growth and increasing influence of consultants.

Consultants and clients alike often ask why the management consulting industry has grown so fast over the last 20 years. Graduating students similarly ask if the growth can be sustained and if career opportunities in the industry will continue to be excellent. Skeptics, such as O'Shea and Madigan (1997), argue that management consultants often do not add real value to their clients and that the industry is a fad—albeit a fad with longevity. Proponents argue that we live in a free and open economy and if clients did not derive value from consulting services, then they would stop using them.

Transaction cost theory helps us understand that there are fundamental reasons why management consultants exist and that the industry is more than a fad. The theory also helps make predictions about the future. Under what circumstances will the industry continue to grow? Is it possible, and advisable, for clients to recapture some of the activities that are now performed by consultants? These issues are discussed in this article, ending with the perspective that the industry will continue to grow and that external management consultants will continue to increase their "problem solving market share."

WHY DO MANAGEMENT CONSULTANTS EXIST?

Drucker (1979) argues that "the management consultant is an extraordinary and indeed truly unique phenomenon." He 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 organization—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 organizations and thus gain exposure. Second, Drucker observes that executives yearn for objective insights into their management problems. Empirical research by Gattiker and Larwood (1985) confirms that clients first and foremost look for stimulation, expertise, and objectivity when they turn to outside consultants. Both these explanations for why management consultants exist are compelling, but they suffer from not being anchored in an underlying theory. Transaction cost theory pro-

vides a rigorous and consistent explanation for the existence of management consulting. To understand the growth of management consulting within a transaction cost economics context, two fundamental questions need to be answered:

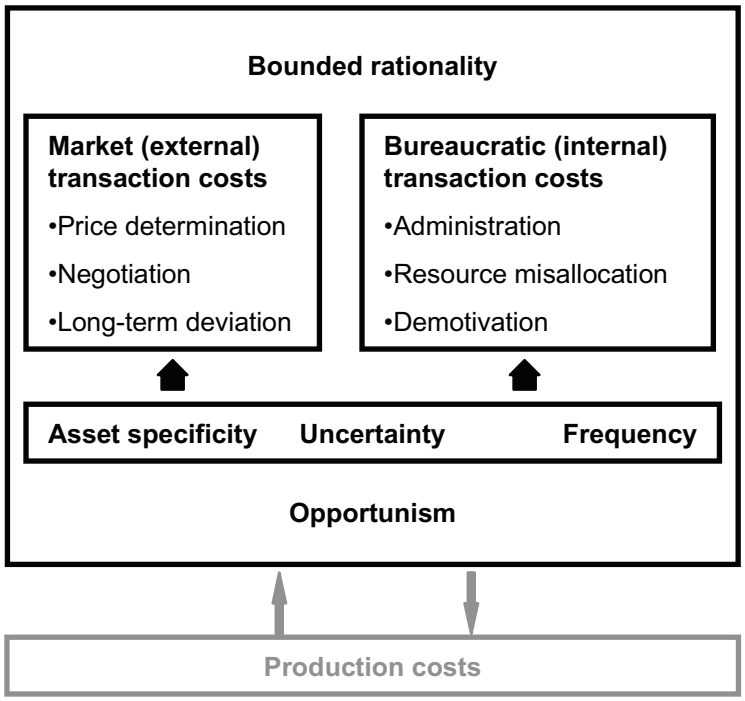
- Why is there increasing demand for the types of services management consultants provide?
- Why is this demand best filled by external consultants who are not direct employees of the firm—but rather contracted outsiders?

Demand for management consulting services

In Part One (Canback 1998), 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 changes in the U.S. 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 coordinating activities within firms), along the lines suggested in the transaction cost framework.

TRANSACTION COST FRAMEWORK



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 U.S. 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 (internal) transaction costs. Using the same methodology, this author found a continued increase in transaction costs over the past 30 years.

To understand this trend, consider how the following underlying mechanism 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 coordination. If transaction costs did not exist, then the largest company would also be the most profitable company in each market, since coordination between functions could be achieved without effort. But with transaction costs, this does not happen. Instead, large companies need to deploy considerable coordination resources to realize 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.

Thus traditional blue collar jobs are disappearing as production costs are reduced, while the number of white collar jobs aimed at coordination 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 cooperation between firms through different forms of alliances and partnerships.

As a consequence, senior executives today deal primarily with abstract issues relating to transaction costs, while 50 or 100 years ago the management task was more concrete and aimed at production cost reduction. 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, and cash management. Other illustrations can be found in old corporate annual reports. In Asea's[1] annual report of 1948 the opening statement concerns factory utilization. The report then continues to discuss manufacturing and product development issues, while it totally ignores what we today call strategic and organizational issues.

Today's executives must still manage production costs, but an even larger challenge lies in optimizing transaction costs. As Herbert Simon (1976) anticipated: "In the post-industrial society, the central problem is not how to organize production efficiently (although this will always remain an important consideration), but how to organize to make decisions—that is, to process infor-

[1] Today part of Asea Brown Boveri (ABB), the Swedish-Swiss electrical engineering conglomerate.

mation." The level of abstraction has increased commensurately. Today we talk about vision, strategic intent, learning organizations, and virtual corporations. We find that most companies' value can not be calculated by studying the income statement and balance sheet alone, since much of the market value is embedded in abstractions such as brand image and intellectual capital.

DEFINITIONS

Transaction costs: the costs of allocating resources in an imperfect world of misunderstandings, misaligned goals, and uncertainty. External transaction costs center around the cost of contracting, internal transaction costs are dominated by the cost of coordination. Transaction costs are often described as "economic friction."

Asset specificity: The degree that a particular asset, or set of assets, is dedicated to a given use. In the context of this article, the degree that a consulting firm's investment in know-how of its professional staff is applicable only to a single client, i.e., human asset specificity.

Uncertainty: Lack of information about the future. In particular, demand volatility and technological uncertainty are important to transaction cost theory. Similar to risk.

Bounded rationality: The notion that human beings strive to be rational in making choices, but since the brain cannot process infinite amounts of information those choices are not always correct.

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

Nature of demand

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

First, bureaucratic (internal) transaction costs stem principally from the cost of administration, the costs of resource misallocation, and the negative impact of demotivation in large organizations. Management techniques aimed at minimizing these can, for example, be found within the fields of organizational design, strategic planning, and govern-

ance. Organizational design influences the cost of administration and the level of motivation significantly. An example is the superior performance of multidivisional organizations over functional organizations (Armour and Teece 1978). Strategic planning reduces resource misallocation by channeling scarce resources into areas where the company has a competitive advantage. The choice of governance models help improve motivation through incentives, and reduces organizational slack such as excessive bureaucracy. These are exactly the kinds of problems management consultants solve.

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, executives primarily need information. 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. Services such as these are offered by management consultants.

In sum, the increase in demand for management consulting services is explained by fundamental shifts in the economy. Today's complex business environment requires high transaction costs to function. This in turn leads to an increasing demand for symbolic analysts—the kinds of professionals found in modern management consulting firms. Stryker (1954) identified this trend years ago when he observed that consultants used to work on "specialized problems—in plant layout, for example, or in wage-incentive programs," but "a relatively new kind of consultant—the man or firm that in effect offers to set a company's basic objectives, policies, structure, and strategies" was emerging.

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 could do the symbol manipulation themselves, or they could use internal consultants. Instead they often use external resources. As a result, since 1980 management consulting has grown by 20 percent per year. It has not always been that way, however. Once upon a time, the executives did indeed do the work themselves. Chandler (1962) describes how executives at the du Pont Company struggled between 1917 and 1921 with how to organize the company. They created working parties and ad hoc committees, and at the same time worked individually on position papers and proposals. 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 *Organization Study* (1919), soon catapulted him into the chairmanship of General Motors—without the help of consultants.

Over time, though, the do-it-yourself approach to solving business problems has decreased in importance because it is inefficient. A senior executive most likely is not familiar with the particular problem he or she is facing and does not know which problem solving technique to apply. This is increasingly true as management becomes more complex, while executives remain boundedly rational (Simon 1976) and do not have the capacity to learn everything.

Thus, the choice for the executive often is whether to turn to internal or external experts for advice. According to transaction cost theory, this choice hinges on the degree of asset specificity, uncertainty due to demand volatility and technological uncertainty, and the frequency of transactions involved (as explained in Part One). 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 factors have worked in favor of using outsiders, although their influence probably is weak. Uncertainty has decreased over the last 50 years, as evidenced by the decline in volatility of the S&P 500 index and of GDP growth. The frequency of transactions is usually low, with most problems to be solved being unique and singular.

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 the consultant rarely moves permanently to the client's location. Dedicated assets that cannot be redeployed are uncommon. The only aspect of asset specificity that truly affects the decision of using internal or external experts is human asset specificity. That is, 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 catego-

ries described in Part One, 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 a client-specific investment, while *Task 8: Permanently improving organizational effectiveness* demands that the consultants have a thorough understanding of the idiosyncrasies of the client organization—an understanding that often takes at least a year to build.

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 holdup 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 organization. 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 avoid the hold-up situation by using internal resources rather than to go through a painful negotiation with outsiders.

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 organization. Indeed, this is the way symbol manipulation was done up till the 1970s, with fast-growing internal consulting staffs (such as those at General Electric and Xerox (Kelley 1979)) 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 minimize the negative impact of high human asset specificity.

First, the theory holds that opportunistic behavior can be expected within and between firms. This opportunism becomes stronger as specialization to realize scale and scope economies increases, since specialization leads to goal conflicts between organizational units and individuals: A manager in marketing may not necessarily have the same goal as a manager in manufacturing, even though the goal of the company is to maximize shareholder returns. Thus, the risk of efficiency losses due to misaligned goals has increased with the growth 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 organization. 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), how-

ever, suggests 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 organizations increased the ability of accountants to detect shirking decreased (Rubin 1990). External management consultants have to a large extent filled this void since they deal with managerial issues rather than accounting issues. 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 organizations that essentially are specialized by competence, they will have seen similar problems before and the cost for leveraging this knowledge base will be low. In contrast, the internal consultants are experts in how their own company works, but they seldom have the size to create an experience base by type of problem.

Also, the external consultant often 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 type of incentive system within the client organization is often difficult since most client organizations are joint stock companies with very different reward systems.

Third, the external consulting firm most likely has higher productivity than the internal counterpart. The main reason is that incentives are more easily tailored to the needs and performance of individuals in smaller organizations, while employees in larger organizations suffer from bureaucratically induced demotivation (and most consulting firms are smaller than the their clients). A parallel is found in R&D where smaller companies have 3 to10 times higher productivity than larger companies (Cooper 1964; Zenger 1994).

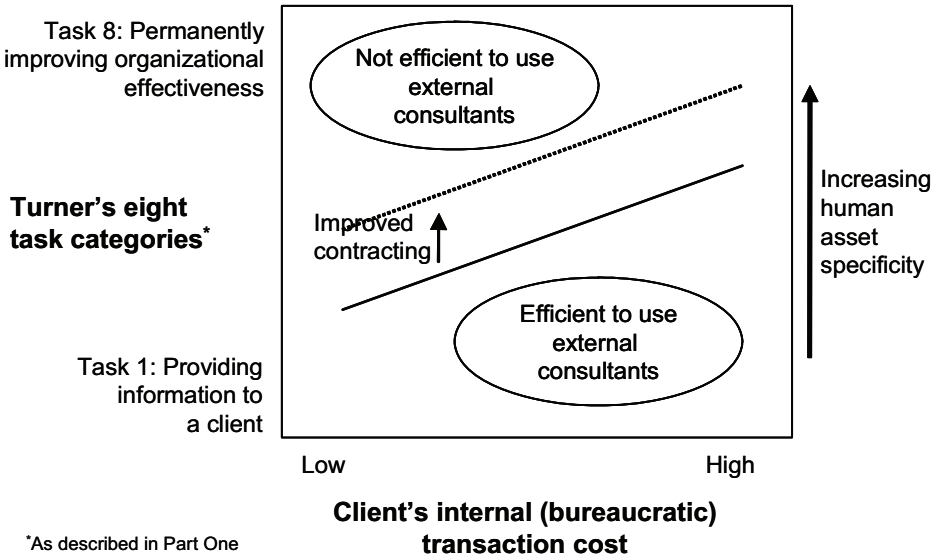
The three factors are advantages held by the external consultants over the internal consultants. In addition, consulting firms often manage to offset the negative impact of high human asset specificity through contractual mechanisms. In accordance with the transaction cost framework, it is in the interest of the external consultant to minimize the cost of price determination, negotiation, and the impact of long-term deviations from the agreed upon contract. Price determination is simplified since consulting firms mostly follow the practice of charging a fixed monthly fee and the cost to the client is proportional to the length of the project.

Negotiations are possibly burdensome, but are alleviated by the management consultant's propensity to use short and standardized proposals. The risk of deviations from the intended task is usually small since most efforts are relatively brief and there is constant feedback between client and consultant. Projects seldom take more than one year, and the norm is three to nine months. Consultants further reduce this 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 consultants to lower the threshold for the client to retain their services.

The above logic can be summarized in the following graph:

Part One posed the question why we have seen an explosion in the demand for management consulting in the United States, but not in Japan. The answer is complicated. Part of the answer lies in Japanese and Americans being at different stages in the management skill development cycle. More importantly, the Japanese management tradition places so much reliance on long-term predictability of careers and a commensurate need to carry organizational knowledge within organizations, that it is difficult for outsiders to be accepted by large corporations. External consultants' disruptive effects on clients' management processes, so far, have outweighed the benefits of stimulation, expertise, and objectivity.

MANAGEMENT CONSULTANTS' DOMAIN



*As described in Part One

* * * *

Management consulting firms exist for good reasons. The nature of management has changed: Unlike in earlier times, abstract issues embodied in the transaction cost part of the economy demand management's attention. Consequently, 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 demand. They bring objectivity, experience, and have high productivity. The cost to the client of working with outside experts is lower than the cost of using internal resources when both direct and indirect costs are factored in. As we will see in the next section, this is likely to hold true in the future as well.

HOW WILL THE MANAGEMENT CONSULTING INDUSTRY EVOLVE?

More than forty years ago, management consulting was considered "one of the hottest—and most influential—growth industries" (Stryker 1954). Today, management consulting arguably is one of the world's most rapidly growing industries. Many expect that consultants will continue to increase market share in problem solving on behalf of corporations and other organizations – and thus continued industry growth. On the other hand, it may be that clients eventually will reclaim the services provided by management consultants—especially those services with high human asset specificity. This would be akin to the disappearance of the inside contracting system discussed in Part One of this series. Under this scenario, the consulting industry could stagnate or even decline.

Continued growth scenario

Remember that the key obstacle to using external resources such as management consultants, according to transaction cost theory, is the degree of human asset specificity involved, and that high uncertainty makes it difficult to use outside contractors. For the growth scenario to materialize the following conditions will have to be true.

First, the current trend towards management consultants' deeper involvement in more and more aspects of solving core problems of their clients will have to moderate; otherwise, asset specificity will increase so much that external sourcing of consulting services becomes unfeasible. Alternatively, contractual arrangements between client and consultant need to be refined at a pace that exceeds the increase in asset specificity (sophisticated contracts can mitigate the negative effect of asset specificity; witness for example the increasing use of success fees which tend to align the objectives of clients and consultants).

Second, client organizations will have to avoid making significant strides in reducing internal bureaucracy costs. If, however, clients can reduce the costs of administration, resource misallocation, and demotivation, then transaction cost theory tells us that it will be relatively more attractive to do symbol manipulation internally. Indeed, highly bureaucratic organizations tend to use more external management consultants do than lean organizations. (A continued high level of internal bureaucracy costs will stimulate demand for external management consultants.)

The third condition what would have to prevail is that uncertainty (in terms of demand volatility or technological uncertainty) will not increase significantly, given that high uncertainty reduces the benefit of buying products or services from the outside.

Were the foregoing growth scenario to develop more or less as outlined, we could, within 15 to 30 years, see a radically different corporate world. Initially, we would see continued rapid expansion of the management consulting industry. Soon there would be as many external symbol manipulators as there are executives in large companies. Over time, the balance of power would shift to the management consultants. They would possess the most knowledge about management practice in general, and their clients' problems specifically. They would own the knowledge networks which will be essential in the global economy. The management consulting firms would also deplete the stock of young, intelligent, and well educated people forming the backbone of the future economy. We thus would see a shift in the balance of influence from the traditional product and services sectors to the symbolic analyst sector, just as in the 1800s we saw a shift of influence from the agriculture sector to the industrial sector.

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

Decline scenario

Under the second scenario, management consulting would be doomed, just as inside contracting once flourished and then declined (see Part One). How would this "doomsday" scenario come to be?

First, the asset specificity of management consulting advice would need to be so high that clients find it difficult to handle the interface between themselves and consultants and, consequently, decide to internalize symbol manipulation.

Second, large corporations would have to develop their management practices to accommodate the needs of different types of employees, both symbolic analysts and routine workers. In particular, this would require differentiated approaches to performance evaluation and the setting of incentives (a process that has already started as evidenced by the escalating compensation packages lavished on executives).

In a third factor leading to a scenario of decline, uncertainty would have to increase to a significantly higher level than it is today.

Fourth, the types of problems handled by management consultants would have to become more prevalent. (Remember, as an activity becomes more frequent there is a tendency to internalize it.)

Should all these things happen, we may live to see a second version of the demise of inside contracting. Clients would initially hire away top talent from consulting firms to do the same jobs as before, and with the same compensation, but now as employees. The alignment of high asset specificity with internal sourcing would over time prove more cost effective than buying consulting services from the outside. Knowledge accumulation then would shift toward the clients, and management consulting firms would find it increasingly difficult to provide high value added advice. However, since management consultants also would be providing an auditing function, and assuming they provided objective advice, they would not disappear entirely. The nature of their work, however, might well shift from Schein's expert and doctor–patient models to the process consultation model, one in which the consultant facilitates and the client provides the expertise.

Under such a decline scenario, external management consultants would work primarily on routine assignments. Yes, they would continue to leverage industry knowledge from client to client, much as McKinsey & Company and others do today. But by its very definition, this knowledge is most unlikely to add unique value to the individual client. Furthermore, opportunities to work on core issues such as strategy and governance would be highly limited. In the end, the consulting process would become substantially streamlined and highly efficient; on the other hand, the industry no longer would be able to attract the best people. Management consulting will cease being "one of the hottest—and most influential—growth industries."[2]

[2] Stryker (1954)

The future role of management consultants

In reality, neither of these two scenarios seem very likely to fully evolve. Nevertheless, looking to the next ten or fifteen years, several factors point to the "continued growth scenario" as the more likely outcome.

So far, the management consulting industry has been able to largely surmount the hurdle of asset specificity and, thereby, redefine an appropriate division of labor between clients and consultants. New forms of collaboration have made it easier for clients to outsource problem solving of core issues. An example is the tendency of consulting firms to strive for long-term relationships with clients as opposed to working on one project per client. Another example is that consultants have been backing away from the classical model of "consultants analyze and recommend, clients decide and implement." Collaboration today is much more sophisticated than it was a mere fifteen years ago, with clients and consultants now working together throughout the entire change process. This trend can be expected to continue.

Of at least equal significance—with or without reengineering and the like—there is no indication that internal (bureaucratic) transaction costs within large corporations will decline. To the contrary, as noted earlier, the transaction cost part of the economy has grown steadily since the 1870s. Nor is this trend likely to be disrupted anytime in the foreseeable future. For one thing, the increasingly global economy adds to complexity. Within large corporations, the demand for coordination continues unabated. New technologies such as artificial intelligence appear unlikely within in the foreseeable future to change this picture.

Finally, there is scant evidence that large corporations will be able to realign their management processes sufficiently in order to be able to internalize symbol manipulation. Stinchcombe (1965) found that the way a company manages itself to a large degree is determined by when it was founded. Most large companies are fairly old and will continue to be so, even though the information technology revolution gradually will change this picture. In the meantime though, it is unlikely that corporate giants will change their modus operandi fundamentally.

If the above arguments hold true, the management consulting industry will continue to prosper. Consultants, together with other external advisers, will play an increasingly important role in the global economy and may ultimately take on the role of network managers. Relationships between clients and consultants will grow stronger and symbiotic. Management consulting will continue to be a preferred career choice for many graduating students at the premier business schools and universities.

This article is a reprint from the *Journal of Management Consulting*, 1999: Volume 10, issue 3, pp. 3–12.

LIST OF REFERENCES

Armour, H. O., and D. J. Teece. 1978. Organizational structure and economic performance: A test of the multidivisional hypothesis. *Bell Journal of Economics* 9 (1): 106–122.

Canback, S. 1998. The logic of management consulting, part 1. *Journal of Management Consulting* 10 (2): 3–11.

Chandler, A. D., Jr. 1962. *Strategy and structure: Chapters in the history of the American industrial enterprise*. Cambridge: MIT Press.

Cooper, A. C. 1964. R&D is more efficient in small companies. *Harvard Business Review* 42 (May-June): 75–83.

Drucker, P. F. 1979. Why management consultants? In *The evolving science of management*, edited by Z. Melvin and R. G. Greenwood. New York: AMACOM.

Gattiker, U. E., and L. Larwood. 1985. Why do clients employ management consultants? *Consultation* 4 (2): 119–129.

Greiner, L., and R. Metzger. 1983. *Consulting to management*. Englewood Cliffs, N.J.: Prentice-Hall.

Kelley, R. E. 1979. Should you have an internal consultant? *Harvard Business Review* 57 (November-December): 110–120.

O'Shea, J., and C. Madigan. 1997. *Dangerous company: The consulting power-houses and the businesses they save and ruin*. New York: Random House.

Paroush, J. 1985. Notes on partnerships in the service sector. *Journal of Economic Behavior and Organization* 6 (1): 79–87.

Reich, R. B. 1991. *The work of nations: Preparing ourselves for 21st-century capitalism*. New York: Alfred A. Knopf.

Rubin, P. H. 1990. *Managing business transactions*. New York: Free Press.

Simon, H. A. 1976. *Administrative behavior*. 3rd ed. New York: Free Press.

Sloan, A. J., Jr. 1919. General Motors Corporation: Organization study. Detroit: General Motors.

Sloan, A. P., Jr. [1963] 1990. *My years with General Motors*. Edited by J. McDonald and C. Stevens. Reprint, with a new introduction by P. F. Drucker. New York: Currency. Original edition, New York: Doubleday.

Stinchcombe, A. L. 1965. Social structure and organizations. In *Handbook of organizations*, edited by J. G. March. Chicago: Rand McNally.

Stryker, P. 1954. The ambitious consultants. *Fortune*, May, 82–85.

Turner, A. N. 1982. Consulting is more than giving advice. *Harvard Business Review* 60 (September-October): 120–129.

Wallis, J. J., and D. C. North. 1986. Measuring the transaction sector in the American economy, 1870–1970. In *Long-term factors in American economic growth. Studies in income and wealth series*, edited by S. L. Engerman and R. E. Gallman. Chicago: University of Chicago Press.

Zenger, T. R. 1994. Explaining organizational diseconomies of scale in R&D: Agency problems and the allocation of engineering talent, ideas, and effort by firm size. *Management Science* 40 (6): 708–729.