THE LOGIC OF MANAGEMENT CONSULTING, REVISITED

In 1998, Staffan Canback published *The Logic of Management Consulting*, an article that is the world's most-used teaching material on the profession.[1]

Here, we have summarized the article and updated it with recent developments.

It gives an overview of the management consulting profession—its history, development, role in changing management thinking, and rationale for existence—and concludes with a brief prediction regarding the future of the management consulting.
First we define what management consulting is:

The management consulting profession renders independent advice on management issues to executives relating to the strategy, structure, and operations of an organization in pursuit of its long-term objectives. This includes identifying and analyzing problems and opportunities, making recommendations, and helping to implement those recommendations.

Background

The management consulting industry has a long history. The first management consultants appeared at the end of the 19th century (30 years after the advent of large companies), and included individuals such as Frederick Taylor, Henry Gantt, Arthur D. Little, and Harrington Emerson. These pioneers mainly focused on increasing client's operational efficiency.

A second generation of consultants emerged from 1910 to 1940. Edwin Booz and James O. McKinsey pioneered and implemented techniques such as budgeting processes, the divisionalized organization, merit-based compensation schemes, and forecasting techniques.

In the 1960s, the profession saw several major developments. Bruce Henderson founded the Boston Consulting Group in 1963 around the concepts of strategy and strategy consulting, with a second generation of strategy specialists such as Bain & Company, Strategic Planning Associates, Braxton Associates, LEK, and Monitor Company following his example.

Even as late as 1980, management consulting was in its infancy. Since then, the industry has experienced rapid growth, with global revenues growing 20% annually between 1980 and 1997, and around 8% annually since then. 85 percent of cumulative management consulting experience has been generated after 1990.

Management Consulting's Importance

More than just a growth industry, management consulting is perhaps the most important and enduring management technique that has been developed since the 1960s, a secondary effect of which has been the rapid spread of new frameworks, tools, and techniques throughout large companies.

[1] *Journal of Management Consulting* 1998, no.2, pp. 3-11; and 1999, no. 3., pp. 3-12

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Management consultants have had a large impact on the state of management as a whole, due to both the quantity and quality of their contributions. For example, the ratio of management consultants to executives has grown dramatically, from 0.1 in 1980, to 0.8 in 2015. For each executive, there is almost one consultant today.

Additionally, management consulting firms employ a high share of graduates from leading business schools; out-competing traditional firms and attracting new graduates.

Innovation in strategy and organizational design is now dominated by management consultants, and not by managers or academics. The same is probably true for other areas of management.

Management Consultants' Roles and Tasks

What do management consultants do?

One way to look at management consultants is by analyzing the types of tasks they work on. Seven task categories[2] describe the activities of a management consultant:

1. Providing information to a client
2. Identifying problems
3. Suggesting solutions to problems
4. Building support for solutions within the client's organization
5. Helping to put solutions into practice
6. Assisting client learning
7. Permanently improving organizational effectiveness

These tasks have varying degrees of client interaction. Consultants act mainly as a supplier of information in the first three tasks on the list, separated from the client by a clearly-defined contract. The last four tasks require more interaction with the client, through a partnership based on mutual trust. Most modern management consulting firms work on the last four higher-value activities, while using the first three as a foundation.

Management consultants also differ in the roles they play in relation to clients[3]:

- "Mental adventurers" analyze long-term scenarios for development by using rigorous economic methods, and leveraging their own experience base
- "Strategic navigators" formulate their own independent perspectives on market and competitive dynamics, without much regard for the client's perspective
- "Management physicians" derive recommendations from a deep understanding of the internal dynamics of the client organization, and often sacrifice some objectivity to gain a realistic perspective on what is achievable
- "System architects" redesign processes, routines, and systems in close cooperation with the client
- "Friendly co-pilots" counsel senior management as facilitators, rather than as experts

These models show that management consultants take on a range of roles in relation to clients, providing everything from information and analysis to methodologies. Many of these roles require a close relationship between client and consultant that goes far beyond a contractually-specified arms-length relationship.

Established management consulting firms such as BCG and Bain & Company fall broadly under the "strategic navigator" paradigm, while firms like McKinsey & Company operate largely as "management physicians".

Transaction Cost Theory

What has been said so far still does not shed much light on why management consultants

[2] Adapted from Turner (1982)

[3] As described by Nees and Greiner (1985)

exist. It is not clear, for example, why managers would want to give away so many of their companies' plans to outsiders, or why it is more cost effective to hire experts from the outside, than it is to do the same work internally. Why, also, is the growth in demand happening now, and not 80 years ago? Transaction cost theory helps us to understand.

Transaction costs are expenditures that result from how companies are organized, rather than from productive activities such as manufacturing, logistics, and product development. They can be either internal or external to the firm.

"External", or "market", transaction costs include: 1) the cost of deciding the price of a product or service; 2) the cost of negotiating a contract; and 3) the cost of information failure (i.e. the cost of long-term deviation from a plan).

The most important "internal", or "bureaucratic", transaction costs are: 1) the administrative cost of deciding what, when, and how to produce things; 2) the cost of resource misallocation (since planning is never perfect), 3) and the cost of demotivation (since motivation is lower in larger organizations).

Transaction costs determine which activities are performed within a company, regulated by the level of bureaucracy, and which types are contracted out to the market, regulated by price. A company will choose to contract services outside of the company when the internal transaction costs of that activity are larger than that of the market (and vice versa).

Applications to Management Consulting

Transaction cost theory can be applied to management consulting to help understand why the profession exists.

First, the increase in demand for consulting services can be explained by large shifts in the structure of the economy. Compared to businesses a hundred years ago, today's businesses have much higher transaction costs (and lower production costs). Transaction costs grew from 29 percent to 60 percent of gross domestic product between 1890 and 2015.[4]

This structural shift in the composition of costs increases the demand for the kinds of professionals found in modern management consulting firms.

Why is this? Consider the following: as companies try to reduce production costs by making use of economies of scale and scope, they need to specialize—which, in turn, has led to a need for internal coordination (i.e. higher transaction costs). Although these internal costs have risen, on balance, the strategy has paid off: productivity has increased, production costs have fallen more than bureaucratic transaction costs have grown, and value has been added.

As a consequence, the role of top management has changed dramatically: senior executives today mostly deal with abstract issues relating to optimizing transaction costs, while a hundred years ago they had more concrete tasks aimed at reducing production costs.

Minimizing transaction costs are exactly the kinds of problems that management consultants solve. For one, the fields of organizational design, strategic planning, and governance are aimed at minimizing internal transaction costs. Additionally, management consultants provide ways to bring information regarding market and competitive dynamics together, which is essential for minimizing external transaction costs.

To summarize, the dramatic shift in the structure of costs within companies has

[4] Wallis and North (1986) for 1890-1970, extended with their methodology till 2015 by EIU Canback

increased the demand for the types of services that management consultants provide, spurring the robust growth of the industry over the last several decades.

Rationale for Using External Consultants

Transaction cost theory also explains why senior executives rely on external consultants to address internal management issues, rather than conducting these activities themselves.

External consultants have been able to use four other transaction cost-related factors to increase demand for their services:

First, increased specialization within companies has shifted the balance of transaction costs in favor of external consultants. Specialization has led to goal conflicts between organizational units and individuals within companies, and has consequently led to a higher risk of efficiency losses due to misaligned goals. (A manager in marketing may not have the same goal as a manager in manufacturing, for example). To reduce this effect, executives need the objective, detached advice of external consultants, who do not have vested interests or loyalties within the company.

Second, external consultants have a wider knowledge base than their internal counterparts, having worked with more clients and in a wider range of industries. Having seen similar problems before, the cost of leveraging this knowledge base is lower for external consultants.

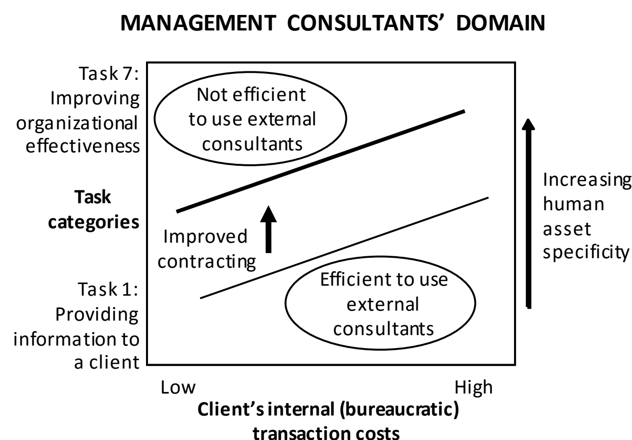
Third, external consultants are likely to have much higher productivity than internal consultants, who like all employees suffer from demotivation in large companies.

Finally, external consultants can offset the negative effects of high *human asset specificity* with the choices they make when writing their contract with the client. Human asset specificity is the extent to which a consultant's knowledge is specific to the client. If human asset specificity is high, there is large risk that either the client or the outside consultant will try to take advantage of the situation.

For example, the client may try to reduce the price for additional work, since it knows the consulting firm cannot easily reassign people who have invested in building an understanding of the client organization. On the other hand, consultants know that it will take the client more time to find, evaluate, and build the knowledge of a new consultant, than it will take to switch consultants.

There is high likelihood that someone would try to exploit this situation. However, this tendency can be offset by simplifying the contract negotiation process. Tactics like charging a fixed monthly fee, using short and standardized proposals, and providing easy exits for clients reduce the external transaction costs related to deciding the price of the transaction, the contract negotiation, and the risks of deviation from the intended tasks.

The above logic can be summarized as follows:



Future Roles of Management Consultants

We have seen how management consultants have been able to leverage society's increasing transaction costs in their favor. These ideas are supported by the high growth the management

consulting industry has experienced since 1980, and continues to experience today.

What is the future of management consulting? It is unlikely that transaction costs will decline anytime in the near future—in fact, increased globalization will only add complexity, and consequently demand for management consulting services.

Thus, it is probable that the industry will continue to prosper, and that management consultants will play an increasingly important role in the global economy.

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