UNDER WHAT CONDITIONS SHOULD DONORS PROMOTE CONSULTING SERVICES IN DEVELOPING COUNTRIES?

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Abstract

This paper examines how the provision of consulting services to businesses in developing countries can be improved by setting out a framework for assessing when it is well justified for donors to intervene in the consulting market. Much donor thinking on consulting services has focused on *how* to deliver the services effectively, but less thought has addressed the conditions for intervention. This paper attempts to fill that gap and offer direction for future research. The paper first describes the donor history of consulting services and tells a story of intervention evolving from direct provision to market intervention and most recently fragmenting along multiple theoretical faults. In response to the volatile conceptual history, the paper lays out a four part framework for assessing whether intervention is well justified under given circumstances. The first piece of the framework requires showing that the benefits of consulting services are greater than the costs in the society. Second, potential market failures are examined to help explain low levels of service provision in situations where benefits outweigh costs. Third, equity rationales for intervention are considered. Fourth, even when potential benefits and a demonstrated market failure exist, donors must have a cost effective method of intervention; the paper provides a description of how to determine if the intervention is cost effective. The framework offers intervention options corresponding to potential problems discovered in steps one and two of the framework.

The paper reaches four conclusions. First, empirical research is required to determine (1) the degree to which business cash flows change due to consulting assistance, (2) the costs of consulting services, (3) the commonness or diversity of knowledge and advice demanded by businesses, and (4) the factors contributing to monopoly. Second, information failure deserve careful attention as a determinant of need for strategy consulting interventions. Third, promoting guarantee schemes is an under explored option. Finally, there may be many circumstances which don't call for intervention.

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Chapter 1: Introduction

Managers worldwide need knowledge and advice about new markets, cutting edge technologies, and profitable strategies. In the developed world, these services are increasingly provided through formalized consulting relationships. By one account, there is one full-time management consultant to advise every two executives in the US.[1] However, formal business-consultant relationships are largely absent in the developing world. This paper examines how the provision of consulting services to businesses in developing countries can be improved by setting out a framework for assessing when it is well justified for donors to intervene in the consulting market.

Seeing the importance of knowledge and advice and being concerned about its apparent absence, international development practitioners have attempted to provide these services to enterprises in developing countries since the 1960s. The reviews of early donor interventions (e.g. Committee of Donor Agencies for Small Enterprise Development) were mixed and led to a progressive reformulation of intervention strategy since the late 1990s. The weight of analysis to date has been on how to provide the services efficiently.

This paper asks the question "Under what circumstances is it well justified for a donor agency to promote strategy consulting services for small enterprises?" Providing knowledge and advice efficiently is a sub point, not the thrust of this analysis. Due to funding politics, practitioner analysis can be biased towards the conclusion that intervention is needed and emphasize *how* to intervene. The option not to intervene is generally absent from the discussion. However, donors with scarce resources should

[1] Steffan Canback, "The Logic of Management Consulting" *The Journal of Management Consulting*, November 1 (1998).

include this option as part of their systematic analysis. The primary goal of the paper is to outline a framework for donors to use in evaluating the justification for business consulting programs according to economic rationales.

This analysis also has a secondary motivation. A careful description of why intervention is rational naturally leads to intervention recommendations. This analysis addresses those intervention options throughout.

This analysis departs from the convention of addressing all business services as a single category and instead focuses on a single business service: strategy consulting. By focusing on a single component of business services, the paper attempts to analyze a homogenous subject and avoid generalizations which are common when all services are lumped together. Choosing to start with consulting services does not imply that donors should start their analysis from a "sector" or "field" perspective. Ideally, the problem in question (poverty, famine, poor health) should be the starting point and the analysis should be guided from there. Looking at the conditions for a specific service allows policy makers to know what questions to ask when a proposal for consulting services crosses their desks.

Understanding where consulting fits in a complex web of sources for knowledge and advice is an important piece of the analysis. As is now widely recognized by development practitioners, strategy consulting is not the major source of these services for most small businesses in developing countries. Consulting competes with knowledge and advice flowing from supply chains, informal contacts, and the media. This paper focuses on knowledge and advice as the relevant markets recognizing consultants as simply one supply source among many.

One clarification of terms is necessary. Business "knowledge" is often referred to as "information" in other publications. This paper uses the term "knowledge" to refer to descriptions of market conditions and technologies relevant to a business's operations. The term "information" is reserved to describe buyers' and sellers' understanding of the availability and quality of "knowledge" and advice services.

Chapter Two lays out the background and history of donor promotion of consulting services. Chapter Three argues that intervention is justified only when the benefits of consulting outweigh the costs incurred and analyzes the sources of these costs and benefits. Chapter Four considers possible market failures that could help explain low levels of consulting services in situations where the benefits of the service are known to outweigh its costs. Chapter Five looks at equity as a rationale for intervention. Chapter Six points out that if donors decided to intervene in the market for consulting services, they need to have an intervention technique that realizes greater benefits than the costs it generates; the chapter explores sources of these costs and benefits. Finally, Chapter Seven provides conclusions of the analysis.

Chapter 2: Background and History

Practitioner thinking about the provision of services to small businesses in developing countries is in a state of flux. In 2005, the United States Agency for International Development (USAID) and the International Labor Organization (ILO) made large shifts in their position on the promotion of business services. These latest changes follow a major paradigm shift made only six years earlier. Despite several decades of effort, the high rate of change suggests that donor agencies are still searching

for viable strategies to stimulate small businesses in developing countries. This section first reviews the definition of strategy consulting services, and then outlines the history of thinking about providing the service to small businesses in developing countries.

2.1 What are "Strategy Consulting Services?"

Strategy consulting (also called management consulting) is the service of providing advice to those in charge of running a business.[2] Strategy consulting improves business performance by identifying opportunities/problems and formulating plans for capitalizing on that knowledge. A variety of terms used by development practitioners are closely related to strategy consulting.[3]

The line between consulting and training in practice blurs, but for the sake of specificity, this paper attempts to draw a clear distinction between the two. Both activities provide an intangible intellectual asset, but training provides a widely applicable skill while consulting endows situation specific knowledge. Consulting requires that the provider know particulars of the customer's business. Training on the other hand can be administered in a relatively anonymous classroom setting. Ultimately, consulting and training are ends of a continuum, but highlighting one end focuses the discussion. It is important to note that consulting and training are often bundled when provided by donors.

[2] *WordNet 2.0*, Princeton University (2003).
[3] "Technical assistance," "market analysis," and "trade linkage creation" are terms which substantially overlap in meaning with "strategy consulting" in the development literature.

2.2 Examples of Programs Providing Strategy Consulting

Programs promoting strategy consulting for small businesses come in a variety of shapes and sizes. Boxes 1 - 3 illustrate a few examples.

Box 1: Development of Malawi Traders Trust (DEMATT)[4]

USAID began funding DEMATT in 1980. During the program's first decade, it offered small businesses a hybrid of strategy consulting services and training through a two stage scheme. First, field officers worked one-on-one with business owners to identify problems and possible solutions. The field officers also assessed whether businesses needed basic training in bookkeeping, production management, or marketing. If such basic needs were found, the field officer then referred the owner to classroom style training with 10 to 15 business owners having similar needs. The program did not charge the businesses for the services.

Box 2: Swaziland Enterprise and Entrepreneurship Program (SWEEP)[5]

SWEEP conducts a business plan competition for inspiring entrepreneurs. The ultimate incentive for the entrepreneurs is financing. However, from the program's point of view, the major service provided is consulting and training. To be awarded financing, the entrepreneurs pass through several rounds in the competition. During these rounds, consultants hired by the program meet with the entrepreneurs to advise them on strategy, market opportunities, and to fine tune their business plan. The consultants' costs are

[4] Russell Webster and Timothy Mooney, "A.I.D. Microenterprise Stock-Taking: Malawi, A.I.D." Evaluation Occasional Paper No. 20, July 1989. Available from www.dec.org.
[5] SWEEP proposal documents, Technoserve.

covered entirely by the program, and thus the services are free to the entrepreneurs. Technoserve began implementation of the USAID funded project in early 2006.

Box 3: Enterprise Support Services for Africa Project (ESSA) [6]

As a pilot program from 1996 to 1999, ESSA brokered engagements between small and medium sized enterprises (SMEs) and local consultants in Ghana. ESSA identified SMEs with growth potential and connected them to consultants. ESSA prioritized clients based on growth potential, willingness to cost share, and number of employees (six or less). After interviewing the owner of a small business, ESSA drafted terms of reference for a contract between the small business and a consulting agency. Because the small businesses generally faced multiple problems, the terms of reference identified stages of consulting that could be served by different consultants. Two types of problems were identified most frequently: inadequate management of knowledge services and operational problems in marketing and production. After drafting the terms of reference, ESSA presented them to consulting firms. In Ghana, ESSA spent time instructing the consultants on how to provide small businesses with quality advice and defined deliverables for the interaction. The consultants typically were well qualified technically but were not well prepared to provide implementation assistance when requested by their SME clients. Based on SME requests, ESSA encouraged consultants to add a period of implementation to their services and provided training to this end.

After brokering the connection, ESSA subsidized the consulting transaction through a cost sharing scheme. In 1999, SMEs assumed between 40 and 50 percent of

[6] Mary M. Lynch and Kwame Young-Gyamp, "Enterprise Support Services for Africa Project," in *Business Development Services*, ed. Jacob Levitsky (London: Intermediate Technology Publications, 2000), 151-164.

the direct consulting costs. This figure excludes the costs of brokering incurred by ESSA. The program hoped that in the future small businesses which participated in the project would better understand when they could benefit from consulting, find an appropriate consultant, and pay for the transaction without subsidy thereby creating a functional market for strategy consulting services.

In general, programs are categorized as either directly providing services or enhancing the local market for the services. DEMATT and SWEEP fall under the direct provision strategy. ESSA followed a market enhancement strategy.

2.3 History of Promoting Consulting Services

The framework for providing a small business with services, including strategy consulting, has undergone numerous restructuring—or in the words of critics, "rebranding"—since the 1970s. Initially, donors categorized strategy consulting as a "non-financial service" and provided it directly. In the late 1990s, non-financial services were renamed business development services (BDS). The new name signaled a change in strategy. Under the new paradigm, promoting markets for services instead of providing the services directly came into vogue. The field appears to be shifting again. Starting around 2005, ideas about "value chains," "making markets work for the poor," and "cluster groups" came to dominate thought on provision of services for small businesses. The more recent ideas concentrate on particular problems discovered during the BDS era. Value chain thinking aims to strengthen service provision occurring naturally in the transaction between manufacturer and wholesaler. Making markets work

for the poor emphasizes that the donor's first priority is poverty reduction which should be at the forefront of project design. Cluster group methodology highlights collective action problems. The following survey and analysis of service promotion history lays out practitioners' experience and thinking on the subject.

Direct Provision

Donor promotion of strategy consulting for small businesses traces its roots to at least the 1970s. Donors started thinking about the problem of small businesses with the question, "What problems do businesses face and how can we solve them?"[7] Framing the issue in this manner led to a two step solution. Donors first set out to identify small business constraints, and then they directly provided corresponding services. Following this thinking, donors provided strategy consulting services—usually referred to as "technical assistance." The DEMATT program (**Box 1**) is a prime example of direct provision.

During the 1990s, the direct provision model slowly fell from favor. The ILO noted the relatively small number of businesses reached, disincentives for private provision, and long-term dependence on donor/government funding as deficiencies of the old model.[8] Commentators have piled on additional complaints about the direct provision of business services.

It was perceived that services were reaching a relatively small portion of businesses. The ILO argued that the availability of subsidy limited the number of firms

[7] Marshall Bear, Alan Gibson, and Rob Hitchins, "From principles to practice—ten critical challenges for BDS market development," *Small Enterprise Development* 14, no. 4 (2003): 12.
[8]ILO, Committee of Donor Agencies for Small Enterprise Development, *Business Development Services for Small Enterprise: Guiding Principles for Donor Agencies – 2001 Edition* (Washington, DC: World Bank Group, 2001)

which could be aided.[9] Hubert Schmitz, a researcher of small enterprise development at the University of Sussex, cites high costs of reaching out to individual firms as a major deficiency of direct provision.[10]

Development practitioners frequently argued that public provision hindered the development of a private consulting sector since private providers could not compete on cost with the subsidized services. The BDS Primer for the 2003 conference in Turin Italy warns that directly providing business services or preferentially treating some providers over others causes serious market distortion.[11] Although empirical evidence of distortion is rarely cited, the assumption dominates the literature calling for a revision to the direct provision paradigm.

Donors expressed concern that the direct provision would always depend on donor funding and never become "sustainable." The ILO points out that many business service projects cease operation when funding is removed.[12] Donors had difficulty justifying programs as "development" which seemed to need funding indefinitely.

The Market Development Paradigm Arrives

The market development paradigm emerged in response to the growing dissatisfaction with the direct provision of business services. Under the new paradigm, business services were referred to as business development services (BDS). Practitioners

[9] Ibid.
[10] Hubert Schmitz, "Fostering Collective Efficiency" in *Mapping the Shift in Business Development Services* edited by Malcolm Harper and Jim Tanburn (ITDG Publishing 2005).
[11] Alexandra Miehlbradt and Mary McVay, "BDS Primer" for the Small Enterprise Development Programme of the International Labour Organization (2003).
[12] ILO, Committee of Donor Agencies for Small Enterprise Development (2001).

concluded that market mechanisms offered solutions to many problems associated with business service provision.

In response to the concern that business services reached only a small percent of the population, proponents of the new paradigm argued that a market focus would multiply interventions' impact. Instead of working directly with small businesses, donors would stimulate innovation in the provision of services to small businesses. As profitable business models for providing BDS were discovered, the supply of BDS would naturally "shift out" and lead to an increased quantity of services provided.

Second, although perhaps a tautology, a market approach was a response to the fear that markets were distorted. If donor provision of BDS was preventing the emergence of a private sector, then donors would withdraw services where a latent private sector potential existed. Also, if the market had failed for another identifiable reason, then donors would address the market failure as opposed to providing services directly.

Third, a path to sustainability was envisioned. As interventions developed appropriate techniques and created greater capacity in the private sector, business services would be financed directly by the beneficiaries. Eventually, donors could exit from the sector.

The new paradigm quickly captured significant attention. In 1999, the ILO's Committee of Donor Agencies for Small Enterprise Development published the *Business Development Services for Small Enterprise: Guiding Principles for Donor Agencies* (subsequently revised in 2001). This guide became the center piece for the new paradigm and was known simply as "The Blue Book." A series of conferences in Harare,

Zimbabwe and Rio de Janeiro, Brazil, in 1999 and 2000 also raised the profile of the new idea.

Although a free market perspective had dominated macroeconomic development policy for sometime, markets as a development tool were applied relatively late to business service provision. The ILO's Blue Book set out guiding principles in 2001. The basic principles address the following program features:

1. *Market assessment*: An initial market assessment is crucial for an intervention in BDS. The market assessment will provide a guide for intervention and serve as a baseline for measuring progress.
2. *Demand versus supply side interventions*: The most appropriate intervention may be on the supply *or* demand side of the business service transaction. For example, on the demand side small businesses might need greater information about the benefits of business services. On the supply side, providers might need training on techniques for working profitably with small business clients. The market assessment should suggest which is most appropriate.
3. *Delivery and payment mechanisms:* Programs should aim to reduce risks and costs for BDS. For example, commissions rather than direct fees may be preferable. Commissions on future revenue smooth the cash flow burden and allow the small business to share risks and benefits with the service provider.
4. *Subsidies:* Subsidies are discouraged because of their potential for distorting markets. When required, a subsidy should be targeted at specific market constraints and be time bound.

5. *Exit strategy:* The time bound nature of intervention implies a foreseeable end. To facilitate a smooth conclusion, the strategy for completion should inform decisions throughout the project.
6. *Focus on technical assistance and incentives:* When circumstances require technical assistance and incentives, this subsidization should focus on creating new technologies for service provision.
7. *Selecting partner institutions:* Interventions should be specialized to particular industries. To cover many industries in an economy, partnerships should be encouraged by various providers.
8. *Role of BDS facilitation:* The intervening agency should assume a role of facilitator and depend on local, private agents to provide the BDS.
9. *Performance measurement and assessment:* Systematic performance measurement encourages design improvement.

After BDS

Development thinking is building new ideas about providing services to small business and slowly abandoning the term "BDS." The shift away from BDS is most starkly evident at the ILO. The ILO gave authority to the BDS idea with its Blue Book and took the lead in promoting the idea through its annual conferences. The ILO also published an annual "BDS Reader" in conjunction with each of its conferences. In 2005, the "BDS Reader" was renamed "The 2005 Reader" and subtitled "From BDS to Making Markets Work for the Poor" to denote the shift away from the BDS focus.[13] "The 2005

[13] Alexandra O. Miehlbradt, Mary McVay, and Jim Tanburn, *The 2005 Reader: From BDS to Making Markets Work for the Poor* (International Labour Organization, 2005).

Reader" notes that BDS has been subsumed into frameworks which more overtly focus on poverty reduction. The ideas BDS represented are now referred to as business service markets, commercially viable solutions, or support markets. New ideas are quickly replacing the market development paradigm and BDS. Two frameworks directly supplanting BDS are "value chain promotion" and "making markets work for the poor."

Value chain promotion assumes business services are embedded within transactions between manufacturer and wholesaler. Small businesses naturally receive needed knowledge and advice by participating in an active market. Therefore strengthening the industry at large and better integrating small businesses become the priorities. BDS practitioners have acknowledged the idea of embedded transactions for some time. The ILO's 2001 Blue Book notes that BDS are often delivered as part of other transactions such as training with the purchase of equipment.[14] However, unlike the BDS market development paradigm which asks, "What interventions would allow markets to better supply services to small businesses?" the emerging paradigm asks, "How can small businesses be better integrated with existing value chains (industries) where they will as a matter of course receive the services they require, and how can these industries be strengthened?"

USAID is one organization at the forefront of the shift towards the value chain hypothesis. Although USAID in its Accelerated Microenterprise Assistance Program (AMAP) (one of the largest studies of small enterprise development by a donor agency) includes BDS as one of its three main areas of study, the agency has moved passed the "market development paradigm" and adopted the value chain hypothesis. The agency moved away from BDS because it perceived the value chain approach as "more holistic."

[14] ILO, Committee of Donor Agencies for Small Enterprise Development (2001).

The study will now look at how industries which support many small firms can be strengthened and how small enterprises can be better incorporated in existing industries.[15]

"Making Markets Work for the Poor" (M4P) is an approach inspired by the Millennium Development Goal of halving poverty and by the power of markets to achieve large scale impact. M4P works from the assumption that although markets are opening up globally, the poor are still unable to exchange their assets and labor in well functioning markets. The approach advocates that development agents focus on "strengthening competitive market systems." The M4P is an approach to development, not a development field per se.[16]

2.4 The Market Development Paradigm in Detail

Although fading from favor, a closer look at the market development paradigm (synonymous with BDS) is useful because it dominated thought on promotion of consulting services during the 1990s. Since the history of the market development paradigm is the history of promoting strategy consulting, many observations made under this paradigm will inform our current understanding of when and how to promote strategy consulting. An examination of the paradigm reveals an idea that drew distinctions on some issues (finance/non-finance), but did not make other important divisions, (private/public goods[17] and strategic/operational services[18]). The paradigm erred more on the side of too few distinctions and was eventually "too big." In effect, it

[15] AMAP Business Development Services: MicroLinks – Microenterprise Learning Information and Knowledge Sharing (4.1.3). http://www.microlinks.org Accessed February 6, 2006.
[16] Alexandra O. Miehlbradt, Mary McVay, and Jim Tanburn.
[17] Alan Gibson, "The Development of Markets for Business Development Services: Where we are and how to go further – A summary of issues emerging from the real and virtual conferences on BDS for small enterprises," Springfield Centre for Business in Development for the ILO (1999), p 5.
[18] ILO, Committee of Donor Agencies for Small Enterprise Development (2001).

attempted to apply a single diagnosis to fundamentally different concepts. This section examines what the market development paradigm entailed.

Box 4: BDS Definition

Business Development Services are any non-financial service provided on either a formal or informal basis designed to serve individual businesses, as opposed to the larger business community.

The definition in Box 4 is unique to this paper and combines the "Blue Book" definition[19] with the definition offered in the BDS Reader[20], two of the most widely cited documents on the subject. The BDS Reader definition limits BDS to non-financial services which the Blue Book does not. The Blue Book restricts BDS to services for the individual enterprise which the BDS Reader does not. This combined definition is more precise than the individual definitions and attempts to reflect the average opinion in the BDS literature. However, definitions of BDS have varied among authors and through time. On the broadest level, BDS refers to all activities performed outside the business on which the business depends. By this broad definition, BDS includes both government functions such as standards regulation and infrastructure provision as well as private sector functions such as advertising and transportation. On the opposite end of the scale, BDS refers to a very limited set of activities such as market research or technical assistance. Under either definition, strategy consulting services would be included.

[19] Ibid.
[20] Alexandra Miehlbradt and Mary McVay.

Box 5: Examples of BDS

Strategy consulting	Advertising	Market research
Knowledge resources	Equipment rental	Realtor services
Accounting	Rental space	Legal services
Telecommunication	Training	

BDS: Finance vs. Non-Finance

Typically, finance is excluded from the definition of BDS. There are two explanations for separating BDS from finance: fundamental differences and the history of donor intervention.

According to the first explanation, finance is fundamentally different from BDS. One of the most substantial differences is the fungible nature of finance. A $100 loan can be turned into whatever the business needs, perhaps services but potentially tangible assets such as land and inventory. Finance also differs from service provision because of the time deferred nature of payment.

The second explanation for dividing BDS from finance is based on the history and politics of donor agencies. Donors divide development agendas according to their own experience and expertise. Many organizations first addressed micro finance as a problem and only later turned their attention to BDS. Such was the case for the ILO, now a leading authority on BDS.[21] Some organizations had long participated in the direct provision of services and built on their political and experiential strength by defining BDS as unique from micro finance. Malcolm Harper describes this division as a "turf

[21] ILO, Committee of Donor Agencies for Small Enterprise Development, (2001).

war."[22] Separating tasks according to specialization presumably creates some efficiencies but does not imply a deep fundamental difference.

It is useful to observe that the distinction between finance and business is somewhat arbitrary. Finance and BDS have important similarities. Both are critical inputs to a small firm's production. Also, finance and BDS both involve transactions which necessitate substantial knowledge of the transaction partner. In finance, the burden is on the loan provider to collect information on the borrower's credit worthiness. In services, the burden of information collection shifts to the small business. In order to evaluate the value of the service, the small business needs a good understanding of the service provider's skills. Given these similarities, lessons may be learned about strategy consulting provision from the field of micro-finance. Although not examined in this paper, these comparisons hold potential for future analysis.

BDS: Public vs. Private Good

Categorizing BDS as public or private goods has important ramifications for intervention yet ambiguity is common. Alan Gibson in the early days of BDS observed that the term public good was used carelessly in BDS circles and that much private provision was already in place although perhaps in a rudimentary form.[23] Gibson's observation became the widely accepted norm when the ILO Blue Book laid out the primary goal of intervention as self-sustaining private provision.[24] Implicit in this goal is the notion that the good in question is a private good. Private goods can be supplied

[22] Malcolm Harper, "Business Development Services for Micro-Enterprises," Enterprise Development Impact Assessment Information Service, http://enterprise-impact.org.uk/informationresources/application.shtml, accessed April 21, 2006.
[23] Alan Gibson.
[24] ILO, Committee of Donor Agencies for Small Enterprise Development (2001).

efficiently by the market because all societal costs and benefits are captured in the transaction. On the other hand, public goods are more likely to require government subsidy.

Despite the assumption that a BDS can become a private good, some discussions of BDS include services that are generally considered public goods. For example, some development agencies include infrastructure and regulation in the BDS category. Even in well developed economies, these functions are still often performed by the state. Most commentators (both Gibson and the ILO included) acknowledge that some services in the BDS category are public goods. Their response to this is that such goods require treatment as exceptions. To be most useful, a framework should address each situation explicitly and minimize exceptions. The BDS framework could have achieved this by drawing a clearer line between which services fall in the BDS category or by clearly laying out the response to public goods situations. Section 4.5 discusses the public goods problem further.

BDS: Strategic vs. Operational Services

BDS commentators have also distinguished between strategic and operational services. Strategic services "address medium- and long-term issues in order to improve the performance of the enterprise, its access to markets, and its ability to compete."[25] Training, consultancy and advisory services, marketing assistance, knowledge, technology development and transfer, and business linkage promotion are considered strategic services. Operational services are services required for the day-to-day operation of the business. These include "information [knowledge] and communications,

[25] Ibid.

management of accounts and tax records, and compliance with labor laws and other regulations."[26] The two types of services are best understood as ends of a continuum rather than separate entities. A simple and useful way to distinguish between the services is by the frequency with which companies employ them. Compared to strategic services, operational services are required much more often. The benefits of strategic services often enhance the ability of the firm to perform and could be thought of as more similar to an investment than a consumable good. Strategy consulting falls in the strategic services category.

The distinction between operational and strategic services potentially leads to divergent intervention strategies. Because operational services are used more frequently, there is less uncertainty about the services' value. As is described later, the level of value uncertainty informs the intervention choice.

2.5 How Small Businesses Could Benefit from Consulting Services

Before discussing when promoting consulting services for small enterprises is appropriate, it is necessary to understand the benefits consulting services could theoretically provide. The benefits break down into two categories, knowledge and problem solving.

Knowledge

Consultants can improve a business's profitability by providing new knowledge. For example, consultants can expose firms to new technologies. This may include better production technologies which reduce the cost or improve the quality of the product.

[26] Ibid.

New technologies would also include management technologies such as how to orchestrate the activities of the firm. Strategy consulting could also lead to new technologies for delivering the product to consumers.

Consultants can also provide market knowledge. This might involve knowledge about foreign markets where their goods are in demand. New knowledge might also come in the form of product characteristics within the firm's technological capability which would demand higher margins. The firm would change product characteristics if they only knew that the change was profitable. The business owner is reaping the benefits of the consultant's wide scope of experience.

Problem Solving Advice

A business owner may hire a consultant to solve a particular problem and advise the owner how to proceed. In this case, the business owner buys the consultant's problem solving ability. The consultant is expected to resolve a problem at lower cost than the management alone could have achieved thereby increasing the firm's profitability.

Planning is a long-run form of problem solving. This could involve plans for ramping up production or contingencies for defending market shares. The consultant offers systematic ways of thinking about the business's future from having seen businesses go through similar situations.

Chapter 3: Efficiency Rationale for Intervention – Part One: Can Consulting Services Be Provided Below Cost?

Greater efficiency is a standard justification for interventions of many kinds. If an intervention can eliminate waste, more resources become available to society and if those resources are gained by the poor, poverty will be reduced. Efficiency gains are often thought of as resulting from correction of a market failure. However, it must first be evident that consulting services could conceivably be produced at a cost less than their value to society. Creating knowledge can be expensive. Once it is clear that consulting could create net benefits, we can examine why the market supplies these services in disproportionately low quantities and look for market failures. The various kinds of market failures which could occur are surveyed in Chapter Four.

It is necessary to specify which markets the analysis is studying. The markets for knowledge and problem solving advice are the pertinent markets for this analysis, not the consulting services market per se. When businesses buy "consulting services" they pay for more than the mere presence of the consultant. They pay specifically for two things, the consultant's knowledge and her problem solving ability. It is important to note that these goods could be provided through strategy consultants but could also be provided by a variety of other means. For example, a business could fill its demand for knowledge and problem solving by hiring a specialist full time, talking with suppliers, or reading trade magazines. The analysis acknowledges all relevant suppliers.

3.1 The Benefits of Consulting Services Must Outweigh the Cost

Intervention may be warranted to promote a more efficient outcome. A given outcome is said to be more efficient than an alternative if it creates greater value for society. Value to society is the social benefits created minus the social costs incurred.

A simple example illustrates how consulting services to small businesses might result in higher value for society. Before consulting is available to a small business, it spends time collecting the knowledge it needs to make production choices at the expense of its normal output. Once consulting is available, the business instead exchanges some of its production for a consultant to find the needed knowledge. The business can now use the time saved to produce more output. If the consultant charges less than the extra output produced by the business, then the business has experienced a net gain in value perhaps leading to greater profitability and wages. If the consultant did not give up a more valuable activity to provide the knowledge, then society as a whole achieves a net gain. In this simple example, the presence of consulting represents an efficiency gain.

In practice, determining if efficiency gains are possible from intervention requires three steps of analysis. The first question to ask is, "Can the services be provided at lower cost than the benefit which they generate?" Information may simply be very costly to produce and not justified by the corresponding benefits.

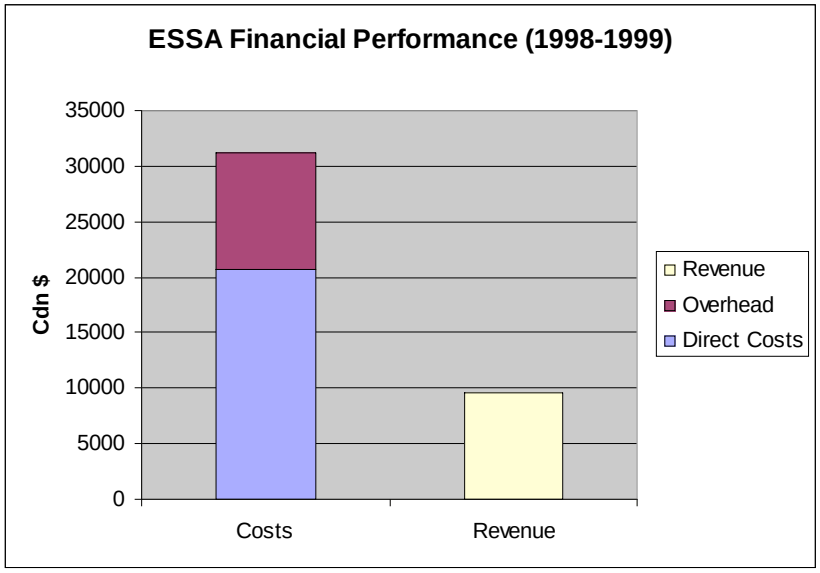
3.2 Examining the Costs and Benefits Associated with Consulting Services in Practice

The ESSA project in Ghana (see **Box 3**) is an example from which a net benefit estimation can be gleaned.[27] ESSA is a brokerage program which connects small businesses to appropriate consultants. ESSA pays the consultants directly (direct costs),

[27] Mary M. Lynch and Kwame Young-Gyamp.

then collects a fee from the small business on a cost sharing basis (revenue). ESSA also incurs overhead costs associated with mediating the transaction (overhead costs). In the first two years of operation, the project worked with 42 small businesses. The average direct costs per client was Cdn$20,725 while the average revenue per client was Cdn$9,600. In 1999, the project expected to reduce overhead per client to Cdn$10,400. Figure 1 illustrates the cost and revenue per client. Over this period, the program aimed to collect 45 percent of direct costs from clients; they exceeded this goal and collected 46.3 percent of direct costs.

Figure 1



Adapted from Mary M. Lynch and Kwame Young-Gyamp

ESSA figures can be interpreted as a rough proxy for the costs and benefits of consulting services by equating revenue with benefits. At first take, the costs of providing the service were roughly three times the benefits received. By this standard,

the transaction was not efficient. Perhaps, but at least one caveat makes this conclusion tenuous—the non-competitive price paid by the beneficiaries.

On the revenue side, benefit accruing to the business is almost certainly higher than the dollar amount which they paid. The firms were not asked to pay the full amount for the service. Instead, program officials set an amount perceived to be reasonable. In all likelihood, firms would have been willing to pay more in a free market setting—although whether this is Cdn$3 or Cdn$30,000 is unclear. It is also important to note that in a competitive market with a single price only the marginal buyer pays an amount equal to her entire benefit received. All others capture some amount of surplus benefit. A more precise valuation of benefit would look at the cash flow streams attributable to the consulting service.

A thorough description of the costs and benefits associated with consulting transactions in developing contexts is needed to estimate net benefits. Just how much benefit do small businesses stand to gain? What are the real costs of creating and disseminating knowledge and problem solving? This analysis should be placed high on the agenda for future research.

3.3 *Factors to Consider When Calculating Net Benefits of Consulting Services*

The case of Box-It, Inc of Casablanca, Morocco[28] helps illustrate factors to consider when calculating whether consulting services can create net benefits. Box-It was a family owned company producing corrugated cardboard. In 1994, despite a solid history of profitable manufacturing, Box-It began to lose sales. Former buyers cited

[28] John Rountree, "Box-It, Inc: Casablanca, Morocco," in *Portraits of Business Practices in Emerging Markets: Cases for Management Education* edited by Richard G. Linowes (Institute of International Education, and U.S. Agency for International Development 1999).

uncompetitive prices as their primary reason for leaving. The management of Box-It was perplexed. They believed they were selling nearly at cost and could not easily see where further improvements could be achieved. To better understand their costs, the management team decided to implement a new cost accounting procedure. Instead of costing according to total monthly expenses divided by monthly production, the new system would account for the actual material, machine hours, and labor used for each particular box run. Previously, all boxes were priced the same. The new system would allow price differentiation and result in reduced pricing for low end boxes. However, the new system would be difficult to implement. New technology was needed to monitor machine activity. Equally challenging, accountants would need to shift priority from measuring input materials to shop floor processes. Box-It decided to employ the services of an Italian consultant to guide them through implementation of the new costing system. The changes ultimately reversed the company's fortunes.

What factors influenced Box-It's decision to employ the consultant? How did Box-It decide the benefits of hiring outside assistance outweighed the cost? While the case study does not address this explicitly, we can make some logical inferences.

The Costs of a Consulting Transaction

Clearly the consultant's fees are a major component of the consulting transaction in the Box-It case. What determines the consultant's fees? "Supply and demand" is the first logical answer but does little to illuminate the issue without substantial market data. Assuming perfect competition, the consultant's minimum average cost will determine the prevailing price for consulting service. While the assumption of perfect competition may

not hold, it provides a useful starting point. So what goes into determining the consultant's average cost? Average cost is the consultant's fixed costs plus his variable costs divided by the quantity of consulting sold. Let's look at each of these components in the Box-It case.

Consultant's Fixed Costs

The consultant's fixed costs represent skills and knowledge acquired throughout his career and education. In the Box-It case, the consultant incurred a fixed cost when he spent the time and resources to become an expert in product costing. This probably included formal education, perhaps an MBA, as well as time spent to keep abreast of new developments in the field.

Accounting for the fixed cost associated with research and development (R&D) of the basic technology is tricky. Did the consultant at some point incur costs related to the actual R&D of cost accounting? Perhaps he did; perhaps he did not. If the original developer of the idea successfully patented the innovation and enforced that patent, then the consultant may have indirectly paid for this knowledge during his education. However, knowledge, as William Easterly illustrates in *The Elusive Quest for Growth,* has a tendency to "leak."[29] In other words, if an idea has the potential to make people significantly more productive, there is substantial incentive for the idea to spread. The consultant may have "ran into" the knowledge during the regular course of his career and incurred very little of the R&D cost.

[29] William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*, (Massachusetts Institute of Technology 2001), p145-169.

Two important factors affecting total cost emerge from the analysis of fixed costs. First, the cost of training consultants will be reflected in the cost of consulting. Given the differences in cost of education around the world, where the consultant is trained becomes an important variable in estimating fixed cost. Second, drawing from the lesson of leaks, the specificity of the knowledge required plays a large role in shaping the fixed cost. If the knowledge desired is applicable across many firms and industries, such as cost accounting in the Box-It case, then it will be relatively costless for the consultant to acquire the knowledge. However, if the knowledge needed is very unique to a given business at a specific place and time—say knowledge about flower preference in New York desired by a Kenyan grower—then R&D costs will have a greater impact of the price paid by the business. In cases of very specific knowledge, the fixed cost is divided across fewer buyers meaning a given firm bears a larger share. In fact, if the knowledge needs to be developed for a single firm, the cost is passed completely to the firm and not thinned over other users. With specificity, R&D shifts from being a fixed to a variable cost.

The impact of fixed costs falls as the volume of consulting services provided increases. As just illustrated, if knowledge is very specific and R&D costs are high, knowledge will be quite expensive. Even if the knowledge demanded is common across many industries, if volume remains low, consulting may be prohibitively expensive.

The examination of fixed costs reveals at least three factors to be assessed when determining if consulting is potentially efficient. First, how much training do consultants need to serve the businesses? Second, how specific is the information required by the

businesses and how much "original" R&D will be required? Third, what volume of transactions could consultants expect to achieve?

Consultant's Variable Costs

In addition to fixed costs, consultants incur variable costs each time they assist a business. In the Box-It example, the individual consultant's time was the primary variable cost. Other variable costs may have included travel, stationary, and phone bills.

The relative weight of variable costs will vary from situation to situation. In the Box-It case, variable costs can be assumed to be relatively insignificant because of the scale of Box-It's operation and potential benefits. However, for a smaller company perhaps located in a rural area, variable costs could quickly accumulate. The EDA Leather Sub Sector Project (**Box 6**) concluded that the consultants infrequently visited the distant villages because of high travel costs.[30] Variable costs need to be carefully assessed before assuming the transaction can be conducted profitably. Donors might face situations were the constraint preventing market transactions for consulting services is due to high transportation costs, not failure in the market for consulting. It then might make more sense to consider helping with transportation than consulting.

Transaction Costs

Both buyer and seller incur costs arranging and executing the transaction separate from the cost of the service itself. These are known as transaction costs. In the Box-It example, transaction costs borne by the business would have included time spent looking

[30] Melissa Nussbaum, Ashok Kumar, and Alexandra Miehlbradt, "Integrating Microenterprises into Markets – The Case of EDA's Leather Subsector Project in India," The Small Enterprise Education and Promotion Network, September 2005. Available from http://www.bdsknowledge.org/

for a suitable consultant and costs related to writing a contract outlining the terms of the engagement. Although not explicitly addressed in the case, the consultant may have costs associated with the transaction from advertising or government required registration/visas. In the ESSA case discussed earlier, the transaction costs are seen quite clearly. ESSA's overhead could be thought of as transaction cost because its purpose is to connect buyer and seller.

Search costs can outweigh the benefits of a transaction particularly for very small businesses. For a small business, a few telephone calls, a couple trips to the nearest large trading center, and the work foregone conducting these activities will consume a larger portion of total revenue than these costs would for a large firm. Since the volume of sales is limited by the small scale of operations, even a substantial improvement in the profit margin per item might not represent a sufficient total gain to cover the costs incurred during the search process.

If donors identify prohibitive transaction costs, they should consider addressing the source of the cost directly. If the transaction cost was the only factor preventing the consulting transaction, once the cost is lowered, consulting will be provided naturally by the market.

The Benefits of a Consulting Transaction

The benefits of an efficient transaction outweigh the costs. Measuring benefits of a consulting transaction can be difficult. For Box-It, the benefits were an improved cash flow due to higher revenue from more competitive pricing. This improved cash flow can be quantified and compared to the cash flow had the company not undertaken the

transaction. The net difference in cash flows is the benefit to Box-It of hiring the consultant. Predicting this value before the intervention can be quite difficult. Even after the fact, it is challenging to isolate the benefits of the consulting from other factors that will have influenced the firm's profitability. Nonetheless, to show the benefits of consulting, donors will need to spend time and energy researching the potential benefits in areas where they are considering intervention.

3.4 Summary of Chapter Three

Interventions in the provision of consulting services are well justified when it is clear the services create net benefits for society. Countries can have "low" levels of consulting for very different reasons. In a country where the costs of creating and disseminating knowledge outweigh the benefits, consulting levels are low because this is the efficient outcome. Donor intervention in the consulting market under such circumstances would only promote inefficient activity. On the other hand, in a country where the benefits are potentially greater than cost yet services are absent, one might rightly describe the level of services as not just low, but *too* low. The question then becomes, "Why is this potential benefit going unrealized?" The market failures that might lead to such as outcome are discussed in the next section.

As described, research is needed on both the costs and benefits of consulting services. How should practitioners of business service development respond if research reveals that the costs of consulting outweigh the benefits? Donors should identify the causes of high cost or low benefits and consider intervening at the source of the problem. If variable costs are high because of expensive transportation or communication, then

improving infrastructure would be a logical response. If benefits are limited because of excessive government taxation, then tax policy might need to be revisited.

Only once it is clear that the transaction could be beneficial is it logically to move on to discussion of market failure.

Chapter 4: Efficiency Rationale for Intervention – Part Two: Do Market Failures Prevent Efficient Provision of Consulting Services?

If the benefits of consulting services do outweigh the costs and yet the market fails to provide knowledge and problem solving, possible market failures should be considered. Markets lead to an efficient allocation of resources when the necessary conditions for perfect competition are met. William Apgar and H. James Brown present four criteria for perfect competition.[31] First, the market has many buyers and sellers. Second, all participants in the market have full information about the market in question—existence of transaction partners, quality of good, and price. Third, there are no transaction costs. Fourth, the transaction has no spillover effects; all costs are incurred by producers and all benefits accrue to consumers. The possibility that each assumption is violated is examined in turn and possible solutions are discussed.

Efficiency is the logical result of perfect competition, but when the assumptions of perfect competition do not hold, opportunities for improved efficiency may exist. Given the assumptions of perfect competition, it is impossible to reallocate resources without making someone worse off (The First Fundamental Welfare Theorem). Under such condition, no government intervention could make someone better off without

[31] William C. Apgar and H. James Brown, *Microeconomic and Public Policy* (Glenview, Illinois: Scott, Foresman and Company, 1987), 204.

reducing the wellbeing of someone else. However, when the assumptions of perfect competition are violated, intervention may promote a more efficient result. Identifying market failures will provide guidance as to the appropriate intervention.

4.1 Market Failure due to Incomplete Information

Full information about the market including its existence, quality of goods, and price, is essential for efficient market operation. Buyers and sellers need this information to determine at what price they would be willing to execute a transaction. Three kinds of information failures are examined in this section: awareness of transaction partners, value uncertainty and asymmetric information.

At the most fundamental level, buyer and seller must be aware of the other party's existence for a transaction to occur. Without the basic information of where to find a seller, the buyer cannot possibly obtain the service desired. In such circumstances, no market transaction will occur.

Surveys demonstrate that basic awareness of business service providers among entrepreneurs in developing countries can be substantially below the ideal of perfect competition. One survey of business owners by Akiko Suzuki for the ILO put awareness rates of the availability of business training opportunities at 41, 50, and 38 percent in Thailand, Indonesia, and Ghana respectively.[32] "Aware businesses" include "those who are aware [that it is possible to buy such] training products, those who have at least some knowledge about the service and those who know where to obtain the service."[33] The

[32] Akiko Suzuki, "Business Training Markets for Small Enterprises in Developing Countries: What do we know so far about the potential?" *Series on Innovation and Sustainablity in Business Support Services (FIT): SEED Working Paper 32*, (International Labor Organization, 2002).
[33] Ibid.

study goes on to cite poor communication channels and lack of communication skill as the primary reasons suppliers are unable to connect to potential buyers.[34]

A study in South Africa also found low awareness of consulting services. The survey by BMI Foodpack divided business services into 16 categories. This differentiation revealed that some services enjoyed much higher awareness rates than the services typically provided by consultants.[35] For example, accounting services were recognized among 74 percent of small business owners and advertising services among 85 percent when definition of the service was provided. However, the services provided by strategy consultants received much lower rates of recognition even with definitions provided. 27 percent of owners were aware of services for business planning advising and 25 percent for new market identification. Like the Akiko study, the threshold for awareness was set relatively low. Businesses only needed to understand that it was theoretically possible to purchase the service in question after having the services defined to be included as "aware." In this survey, aware business owners need not know where to actually purchase the service.

These surveys suggest many business owners do not even consider going to the market to procure knowledge and problem solving services. According to an information failure argument, potential value is not created because buyer and seller aren't aware of the other's existence. Critics of this conclusion may argue that the services in question don't create net benefits and therefore there is little reason for information about the services to spread among the small business community. This is a valid observation and

[34] Ibid.
[35] BMI Foodpack, "Market Assessment of Business Development Services: Summary Report" Deutsche Gesellschaft for Technische Zusammenarbeit, (Nelspruit, South Africa, 2004).

reinforces the importance of first determining that the knowledge and problem solving can be supplied at a net benefit as outlined in Chapter Three.

Value uncertainty is another potential manifestation of an information failure. Assuming buyer and seller now know that the other party exists, they still need sufficient information to assess their respective costs and benefits to determine whether the transaction is profitable. From the buyer's point of view, information about the knowledge market is inherently uncertain. If a buyer already knew in perfect detail the knowledge she wanted to buy, then she would already have the knowledge and there would be no need for a transaction.

A buyer's willingness to pay for knowledge reflects both the chance that the information is very useful and that it is not. Returning to the Box-It case discussed earlier, if by Box-It's best information there was a 50 percent chance the costing system would increase cash flows and a 50 percent chance that it would not, then the business would be willing to pay substantially less than if it was certain of increased cash flows.

Finally, the third type of information problem—information asymmetry—arises when suppliers know more about the nature or quality of the good or service than do buyers. George Akerlof classically outlined this problem in the "The Market for 'Lemons'" with an illustration of the market for used cars.[36] He concludes that when a good can express various levels of quality, yet buyers are unable to determine the quality level, markets may fail to operate efficiently.

There are similarities between the markets for consulting services and Akerlof's market for used cars. Following Akerlof's example, assume there are two types of

[36] George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *The Quarterly Journal of Economics*, Vol.84, No. 3 (Aug., 1970), p 488-500.

consulting services—low quality and high quality. Buyers know that there are two types but are unable to distinguish between the two and so only a single price prevails in the market. The price falls below the price high quality consultants would receive if they could differentiate there service.

At this point, the consulting story diverges from Akerlof's. In his example, sellers of high quality cars become unwilling to transact because after the sale, they can't turn around and purchase a high quality new car because they received a low price in the used car market. They are "locked in" with their current vehicles. Consultants on the other hand don't give up the ability to benefit from their services when they work with a business. They can still sell their services again the next day.

Although consultants are now receiving a lower price, they may or may not continue to engage in providing the service. To determine if the high quality provider will sell is a matter of comparing their cost and benefit analogous to the discussion in Chapter Three. If they can recover their costs, even at the lower price, they may still come to market. If not, they will exit the market.

The market for consulting may continue to break down from this point. If the cost of creating consulting to a high standard is greater than the average price prevailing with no differentiation, then high quality consultants exit the market and only low quality consultants remain. If the low quality consultants could only cover their costs when the price was pulled up by the presence of high quality consultants, then they will exit as well leaving the market with no consulting.

An algebraic explanation helps illustrate this point. There are three market prices to consider. P^H would be the equilibrium price for high quality consulting if buyers could

differentiate between consultants. P^L is the price for low quality consulting with differentiation. P^A is an "average price," the price the market pays when buyers can't differentiate. Under our assumptions: $P^H > P^A > P^L$. To tell the break down story we assume that the costs for high quality consultants are greater than the average price but less than the high price: $P^H > C^H > P^A$. For low quality consultants, their cost is less than the average price, but greater than the low price: $P^A > C^L > P^L$. Assuming no differentiation, the price begins at P^A. At P^A, high quality consultants can't cover their costs and leave the market; low quality consultants can cover cost and stay. However, once the market realizes that there is zero probability of receiving high quality consulting, the price drops to P^L and even the low quality consultants are driven out. Of course, if C^L is less than P^L, the market continues to function but only with poor quality services.

These examples illustrate how asymmetric information could lead to market failure, and that if buyers can't differentiate, the cost of providing the services becomes even more important. As described in section Chapter Three, donors need to carefully research the relatively cost and benefit of providing consulting services. Even if such research reveals that the benefits justify the cost, the market may still breakdown because of information failures.

Box 6: Leather Artisans in India [37]

Indian leather artisans faced a challenging yet promising business climate in 2002. Their primary product, traditional leather sandals known as "jootis", was disappearing in favor of plastic sandals. However, the demand for modern leather sandals was increasing

[37] Melissa Nussbaum, Ashok Kumar, and Alexandra Miehlbradt.

in urban areas. Unfortunately, many small artisans' did not have the technical expertise to produce the modern designs according to a market survey by EDA.

EDA's market research identified poor connections between leather artisans and sources of knowledge about urban markets. Although artisans were generally aware that services for adopting modern designs and technologies existed, they were not sufficiently connected to urban markets to know where to acquire such information. To fill this gap, EDA worked as a broker introducing artisans and advisors/trainers.

EDA also observed evidence of firms undervaluing private consulting services. Many artisans were unwilling to pay for services from EDA trained specialists because the government offered similar services for free. Despite the preference for the free government services, artisans were generally much less satisfied with government services than they were with the services wholesalers or exporters according to EDA assessments.

Why weren't artisans willing to pay for the additional quality of services? Their unwillingness could be symptomatic of incomplete of asymmetrical information. If artisans were unable to distinguish the quality of private consultants' product from the government's product, then they would rationally choose based on price alone and favor the free government service. Even if artisans suspected that some of the consultants had quality advice, they would still discount its value if they suspected other consultants offered poor advice. Of course businesses may also discount the government's advice, but given that its cost is so low—a time commitment but no financial cost—the net benefit may be perceived as greater.

EDA decided that an information failure was the key issue and designed a corresponding intervention. EDA worked to provide complete information to artisans about the quality of consulting services. They held workshops to explain exactly what services are available and what they consisted of. Business people were free to ask questions of the providers. EDA not only facilitated information sharing but also tacitly accredited the consultants.

4.2 Market Solutions to Information Failures

Before considering how a donor might intervene to correct failures in information markets, it's useful to examine how the market might naturally address the problem. Since both buyers and sellers are hurt by information failures, solutions to the problem may naturally arise.[38] Providing signals or insurance of quality are two theoretical options for addressing information failures.

The natural market solutions for addressing information failure are discussed before turning to possible interventions in the next section for two reasons. First, if market solutions are working effectively there will be less need for intervention. The pervasiveness of information market failure and its natural resolution is the subject of recent economic debate[39] and donors should be cautious about jumping to conclusions based on information failure arguments alone. Second, donors will want to consider gearing interventions to strengthen naturally correcting tendencies in the market. For example, if a nascent, private accreditation program is attempting to provide signals of

[38] Andreu Mas-Colell, Michael D. Whinston, and Jerry R. Green, *Microeconomic Theory* (Oxford, UK: 1995), 450.
[39] Tyler Cowen and Eric Crampton, *Market Failure of Success: The New Debate* (Northampton, Massachusetts: Edward Elgar Publishing, Inc., 2002).

quality, efforts to accelerate the program's development may have a sustainable and long-term impact because the market demands the service.

Signaling, first investigated by Michael Spence, is the idea that high quality suppliers will find ways to convey the superiority of their goods or services through costly activities.[40] High quality suppliers are willing to assume costs for signaling activities if they believe such activities will generate net profits due to differentiation of their service from inferior services. In order for the signaling activity to be effective, it must be the case that the activity is less costly for high quality suppliers than low quality suppliers. Otherwise, low quality suppliers would also undertake the activity and differentiation would not occur.

Providers of knowledge and problem solving can take advantage of Spence's classic example of signaling—education. If education is easier (less costly in terms of effort) for highly productive knowledge providers and problem solvers, then future strategy consultants can undertake difficult degrees to signal to small businesses that they will provide good value.

The extra cost of education must eventually be reflected in the consultant's fees which may or may not impact the ability of small businesses to pay. The clients in question are at least stereotyped as cash strapped. If this is the case, education may be too costly an activity to justify signaling when the target clientele are small businesses in developing countries. However, the cost of the consultant's education is spread out across many clients and possibly numerous years. If the cost is sufficiently "thinned," small businesses may have little trouble paying for the service.

[40] Michael Spence, "Job Market Signaling," *Quarterly Journal of Economics*, Vol. 87, No. 3 (Aug., 1973), 355-374.

Consultants are also faced with the challenge of finding a signaling mechanism which small businesses will adequately understand. In order for a degree program to provide a meaningful signal, small business owners must be attune to the differences between the rigorousness and relevance of various programs. In practice, it could be more difficult to obtain knowledge about degree programs than the business knowledge the firm actually desires.

Service providers can signal the quality of their knowledge and problem solving ability through a commitment to buy products from trainees. This type of transaction is known as bundling. Typically the small business pays no upfront cost at the time services are provided by the committed buyer. When the time comes to purchase goods from the small business, the cost of the advising services is reflected in a slightly lower price for the goods. This transaction can be thought of as signaling because the supplier of knowledge is incurring a cost, the future purchase of goods. From the small business point of view, uncertainty about the value of the service is reduced since the small business recognizes the service provider would be reluctant to commit to the purchase of goods if the training was to be of poor quality. Inferior service providers should self select out of bundling transactions. If a supplier suspects the training he provides is low quality, then he would also know the quality of the trainee's goods would not improve and that it would not be wise to buy from this supplier in the future. Information asymmetry is reduced when both parties have a similar stake in the outcome.

Insurance is another possible market solution to the problem of uncertainty if it can be provided at an affordable cost. As Harold Demsetz points out, when risk mitigation is thought of like any other good, the problem of incomplete information

disappears. According to the Demsetz's explanation, small firms should theoretically go to the market to purchase insurance to cover the uncertainty associated with consulting services.[41] Demsetz argues that when we don't see transactions being insured, it is because the price of insurance outweighs the benefits to the firm. One might expect this to be the case with insuring consulting. For example, insurance is relatively costly when assessing success or failure of the outcome is complex and time consuming. This would likely be the case of judging the outcome of a consulting transaction which does not always lend itself to objective, short term indicators of success. In the face of high insurance costs, the lack of insurance of small business consulting is the result of resource allocation in the face of scarcity, not market failure.

4.3 Intervention Solutions to Information Failures

If the problem is lack of awareness, the donor could promote brokerage services which connect buyer and seller. The ESSA project described in **Box 3** is a good example of this kind of intervention. Recall that ESSA identified small businesses that could benefit from consulting services then matched the businesses with appropriate suppliers.[42] In that case, before the intervention, both suppliers and buyers were unaware that they could benefit from interaction.

Brokerage promotion could take the form of direct provision or subsidy. Again, the ESSA case illustrates how direct provision would look. In other situations, a subsidy to private firms brokering arrangements between small businesses and consultants could

[41] Harold Demsetz, "Information and efficiency: another viewpoint," in *Market Failure or Success: The New Debate,* ed. Tyler Cowen and Eric Crampton (Northampton, Massachusetts: Edward Elgar Publishing, Inc., 2002) pg 107-119.
[42] Mary M. Lynch and Kwame Young-Gyamp.

overcome the information failure. In cases where buyer and the seller would benefit were they put in contact, the broker is creating value for which he could charge the two parties. However, if the broker's costs exceed the willingness to pay of the parties, a brokerage system will not emerge. By offering subsidies to brokers, the donor could make the transaction viable. In order for this intervention to be socially desirable, it must be clear that the transaction would be profitable but for the market failure. The value analysis in Chapter Three is crucially important before enacting a subsidy.

Subsidies may or may not be long-term in nature. If a greater quantity of transactions through a network effect led to widespread awareness of buyers and sellers, brokers could become unnecessary or at least lead to lower brokering cost. Either way, the subsidy becomes unnecessary. On the other hand, severe market differentiation could prevent brokering costs from falling substantially. If the individual requirements of businesses are highly diverse such that transactions are relatively unique, then a network effect will not emerge. For example, business A could know that business B benefited from problem solver X, but if business A's problem is sufficiently different, then A needs problem solver Y of whom both A and B have no knowledge. Determining the degree of market differentiation is a question for future research in the field. Just how common or unique are the problems of businesses in developing countries?

Another common strategy for promoting awareness is advertising. Donors could sponsor advertising campaigns on behalf of knowledge and problem solving providers. This naturally raises the question, why weren't advertisements already being run by suppliers? Suppliers would not be running advertisements if they truly believed there were no potential demanders. Suppliers might also not advertise if the ads had a public

good effect and a particular provider was only able to capture a fraction of the benefits (public goods are dealt with in more detail later). Also, like brokering, the advertising might not be profitable and require a subsidy for a period of time. Depending on how demand for consulting services changes with greater exposure, the subsidy may or may not be needed for an extensive period of time.

Donors could instruct service providers on the value gained by guaranteeing the quality of their work. A service guarantee by the provider is similar to an insurance policy. However, unlike a third party policy, the provider has immediate knowledge of the project and can assess with greater ease whether the service succeeded or failed. Donors could provide technical advice about managing and pricing such a scheme as well as highlighting the potential benefits from increased sales and premiums.

Guarantees adjudicated by the consultant raise a serious conflict of interests. The consultant has overwhelming financial motivation to conclude that the service was rendered successfully and that no repayment is due. Guarantees are only successful when the consultant places a very high value on his reputation and knows that a suspicious rejection of a refund request will damage his reputation.

Donors could help formalize the role of reputation through an accreditation program. An accreditation program would evaluate the previous work of consultants and accredit those providing excellent service. In effect, accreditation provides a signaling mechanism for consultants. Inferior consultants could attempt to receive accreditation, but the effort and thus cost required to meet the standards would be higher than for a quality firm. Quality firms would consequently be more likely to not only receive, but also seek accreditation as long as the process was sufficiently rigorous.

4.4 Market Failure due to Monopoly

The section examines the possibility of monopoly problems in the market for consulting services. Perfect competition and thus market efficiency requires many buyers and sellers so that no individual firm can affect market price. From a societal perspective, monopolistic markets do not clear an optimal quantity because additional units of the good can be produced creating greater benefit than cost incurred.

As Robert Pindyck and Daniel Rubinfeld explain, monopoly power arises when a monopolist faces an inelastic demand curve. The elasticity of a firm's demand curve and thus the likelihood of monopoly are shaped by three factors[43]:

1. The elasticity of market demand
2. The number of firms
3. The interaction among firms

Each of these is examined in turn.

The elasticity of market demand for strategy consulting requires empirical research; deductive reasoning alone will not be sufficient to determine whether the elasticity is high or low as two observations make clear. On the one hand, the demand for problem solving should be relatively elastic since every firm has an innate capacity to do this work "in house." From that perspective, the firm has a reasonable substitute should the price of the service increase and can adjust quantity consumed. On the other hand, basic knowledge—for example the location of potential buyers—is so crucial to a firm's survival that its demand is conceivably very inelastic. The two key components of consulting service point in opposite directions: problem solving towards elasticity, and

[43] Robert Pindyck and Daniel Rubinfeld, *Microeconomics*, (Pearson Education, Upper Saddles River, NJ: 2005), 357.

knowledge towards inelasticity. Reaching a conclusive statement on the elasticity of demand for market service is tenuous at best without empirical research.

The second determinate of monopoly power, the number of firms capable of providing consulting services, also needs careful assessment in each market. Many firms erode the possibility of market concentration and make monopoly less likely. A "firm" providing knowledge or advice need not be a formal consulting business. Any source of substitute services will serve to erode market power to some degree. Donors have come to recognize that "consulting" services are distributed through a variety of sources. Keith Mardsen points out a host of sources for business service provision[44]:

1. In Malawi, a tobacco estate receives technical information about new pesticides from the manufacturer.
2. In Côte d'Ivoire, a froze-fish exporter received design and installation assistance for his new factory from a local manufacture of refrigeration equipment.
3. In Ghana, an advertising agent and printer receives advice from his major clients. The agent's banker helped the business install a new accounting system.
4. In Tanzania, a food manufacturer and sisal owner receives information on customer preferences from his wholesaler.

Mardsen's examples suggest the possibility of competition among providers of services in developing countries, but the facts on the ground are likely to vary in each case. In particular, Marsden's observations may be accurate for many urban or large scale producers, but one can imagine how small, rural producers might have difficulty linking to quality information. In such cases, a single provider could exercise monopoly power.

[44] Keith Marsden, "African Entrepreneurs: Pioneers of Development," in *Mapping the Shift in Business Development Services* edited by Malcolm Harper and Jim Tanburn (ITDG Publishing 2005).

Third, if firms interact in such a way that collusion becomes possible, monopoly power can arise. In general, collusion becomes difficult with many players because individual firms have incentive to "cheat." Market assessment surveys will want to try and gauge the interaction among firms to test for the possibility of collusion.

The business service literature is rarely concerned by the possibility of monopoly despite not ruling it out in a systematic fashion. Monopoly power may be problematic when all three criteria point to an inelastic demand curve for the monopolist firm. Donors apparently dismissed the possibility of monopoly when they began highlighting the presence of embedded services and thus drew a picture of markets filled with small, informal providers of consulting services. However, embedded services may only be available to certain classes of business. Also, it is not entirely clear that the advice provided is always in the best interest of the small business since the provider often has a vested stake in the transaction. Further research would help clarify whether or not monopoly is a problem in consulting services and help shape the intervention agenda.

4.5 Market Failure due to Public Goods Problem

When it is difficult to charge for use of a good, suppliers will produce less than the market would like to consume and a "public goods problem" is said to exist. Knowledge creation among small businesses may suffer from a public goods problem. Among small businesses where community is quite tight, there is a natural tendency to share knowledge, intentionally or otherwise. If a consultant provides knowledge to a business about a new technology or profitable market, this knowledge may travel to nearby businesses by word-of-mouth or simple observation. The community may benefit

greatly from the information, but the consultant is only able to charge the first person who received the knowledge. The first recipient will only be willing to pay his marginal benefit which may not be sufficient to prompt the consultant to generate the knowledge in the first place.

Problem solving may or may not suffer from a similar problem. If individual businesses suffer from unique combinations of problems, transferring solutions from one business to another will not produce additional benefit. In this case the problem solving is excludable. However, the problems in a given community might be quite similar. In this case, the solution to the problem quickly becomes analogous to a piece of knowledge and the public goods problem emerges.

4.6 Intervention Solutions to Public Goods Problem

Direct government provision and subsidization are common responses to public goods problems and an option in the provision of consulting. Consulting services could be funded by tax payers thereby eliminating the possibility of free riding. Direct donor provision achieves the same ends. Subsidization lowers the price of consulting to buyers while raising it for providers effectively increasing the quantity consumed by simultaneously increasing supply and demand. Either strategy implies deadweight loss associated with taxes and subsidies. Empirical analysis is required to determine whether government provision or subsidization is more effective.

An intervention could seek ways to permit exclusion of those that don't pay. Unlike direct provision which seeks to by pass the market and directly raise levels of consumption, a method of excluding free loaders would move consulting to a private

good and allow market forces to operate. Maintaining secrecy or preventing the free spread of commercial knowledge becomes the objective. For example, interventions could work to make non-disclosure agreements legally binding by strengthening legislation and enforcement.

Chapter 5: Equity Rationale for Intervention

While efficiency may be desirable, it is not the only measure of a "successful" economic system. Society cares not only about the total resources in an economy, but also about how the resources are distributed. In pursuit of greater equity it may be desirable to reallocate resources even without an efficiency improvement.

Poverty alleviation alone could justify intervention in consulting markets. There are two major issues to address when considering how well an intervention is justified. First, does the intervention indeed help the poor? Second, how "relatively efficient" is the intervention at helping the poor? In other words, a consulting intervention helps the poor at least as much as other alternatives without posing additional costs compared to other interventions.

When assessing whether or not a given consulting intervention will help the poor, donors should consider at least three channels through which the program could help the poor. First, the intervention could help the poor if the owners of the businesses are poor. The line of causation is straightforward. If the intervention can improve firm profitability and the profits accrue to a poor owner, then the poverty of the individual will be reduced. Second, the intervention might generate employment or higher wages for the poor. If the firm hires more of the poor as a result of the consulting, this could achieve poverty

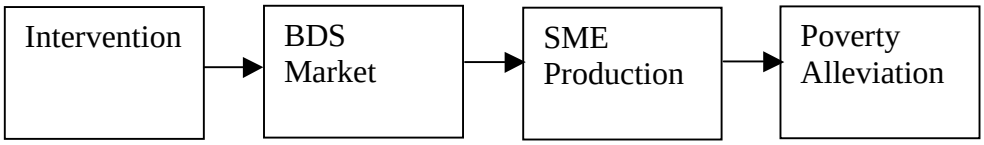
reduction. Wages might improve if the impact market wide is sufficient to alter the total supply of labor; this seems quite unlikely for a single small business to achieve but the potential exists for the net effect of many successful interventions to impact the whole market. Wages might also improve if the business provides training to the employees increasing their productivity. Third, poverty is reduced if the consulting results in more efficient production of goods consumed locally by the poor and lowers the price of these goods.

After examining if the intervention actually helps the poor, program designers should consider the relative efficiency of the program. Does the intervention help the poor at the same level as other programs while imposing no more costs to the rest of society? Ultimately, empirical evidence would be required to determine whether subsidizing consulting services was a more or less effective way of channeling resources to the poor. Donor's should compare the consulting promotion program to others working towards equality.

To bolster the claims of "relative efficiency", equity arguments can work in tandem with efficiency arguments. By correcting a market failure, the intervention will not only divert more funds to the poor, but also fundamentally correct one of the causes of poverty and therefore decrease future need for subsidization. Bear, Gibson, and Hitchins emphasize a "core logic" for delivering business services to SMEs which follows the pattern of achieving efficiency gains to reach the ultimate equity goal.

According to their model, interventions should directly interact with business service markets which in turn impact SMEs. The impact on SMEs trickles down further to poverty alleviation. Figure 1 illustrates their line of thought.[45]

Figure 2: Causal Path from Intervention to Poverty Alleviation



Adapted from Bear, Gibson, and Hitchins.

By correcting market inefficiencies, there is an assumed long-term multiplier effect of the donor's initial resources because the intervention corrects a fundamental problem in the economy. Without the inefficiency, equity interventions may simply be a temporary gift of extra consumption. The fear is that once donor funds are exhausted, consumption returns to the old level. Correcting inefficiencies addresses critics of direct provision who argue that the impact of direct provision is seriously limited in terms of duration and scale.

Chapter 6: Measuring the Costs and Benefits of Intervention

All interventions come at a price. Naturally, the benefits must justify the costs. Finding market inefficiencies or having an equity goal is necessary, but not sufficient justification for an intervention. There must also be a method for conducting the intervention at an acceptable cost. As Demsetz argues, analysis which presents only

[45] Marshall Bear, Alan Gibson, and Rob Hitchins.

efficiency arguments comparing theoretical perfection to reality is a *nirvana* approach to intervention. Better is a *comparative institutions* approach which considers the various options for economizing given scarce resources.[46] Comparing institutions boils down to comparing the costs incurred with the benefits created by the intervention.

The challenges of analyzing the benefits and costs of intervening in consulting markets are to identify all relevant costs and benefits, measuring these factors, and applying a common denominator. Donors need to be aware of costs from two basic categories. They need to account for costs of the program itself and for the indirect costs the intervention imposes on society at large through market distortions and other undesirable side effects. Benefits are similarly categorized. Direct benefits are measured by improvements in the lives of those with whom the program directly interacts. Indirect benefits are generated by the changed behavior and assets of direct beneficiaries positively impacting others in the society.

The remainder of the chapter lays out some of the most important costs and benefits of intervention which donors will need to consider.

6.1 Measuring Benefits of Intervention

One particularly challenging aspect of assessing benefits is accounting for supplanted sources of knowledge or problem solving. Donors need to remember that they are looking at *net* benefits of the intervention. In the case of strategy consulting, this can be particularly tricky to assess. Although market assessments may show businesses consuming very little traditional strategy consulting, the businesses may be obtaining the services bundled with supplier/wholesaler transactions or through informal interactions

[46] Harold Demsetz.

with other businesses—embedded services. If an intervention made formal consulting possible, the small business would most likely reduce their consumption of other knowledge and problem solving sources. The intervention's benefit would be the difference between the quality and quantity of services received through the original arrangement and the new situation. The pre-intervention analysis will need to carefully consider possible sources of current problem solving and knowledge.

Interventions might also improve the competitiveness of one firm at the expense of another. For example, if employment is used as an indicator of benefits, the analysis needs to look at the full impact of the intervention on the labor market. Although participant firms may increase employment after receiving consulting advice, did these workers simply come from another business? If so, the intervention may be perceived as a cost by stakeholders in the businesses losing trained employees. If the intervention simply rearranges trading relationships, benefits are redistributed, not created. However, the expectation is that when workers leave one business to join another, they do so because they are more productive in the new sector and therefore receive higher wages. As James Winkler and Donald Snodgrass point out in a survey of enterprise development strategies for USAID, economic growth is associated with a "dynamic flow and churn of private enterprises." The birth and death of businesses is to be expected, but the changes should be the result of higher productivity, not a shift in power relationships facilitated by the intervention.

The measurement of program benefits is a serious challenge. The donor community has work to do creating and measuring common indicators for assessing the

impact of consulting interventions and business service interventions more generally. Consensus is still forming about what indicators should be used

Eric Oldsman and Kris Hallberg, writing for the German development agency GTZ, offer indicators to measure benefits based on the causal steps of BDS intervention. Returning to **Figure 1**, Oldsman and Hallberg suggest measuring impact along each step of the causal path, not necessarily at the end point alone. At the business level, this would involve measuring indicators such as defect rate, order-to-delivery time, customer rejects, net profit, employment, and more. They emphasize that outcome indicators will depend on context, intervention goals, and data availability. "*There is no one set of measures that will fit all small enterprise initiatives*" (original emphasis).[47]

Jeanne Downing, Michael Field, and Donald Snodgrass reporting to USAID's Office of Microenterprise Development challenge the conclusion that establishing common indicators is impossible. They point out that many different BDS interventions have very similar intermediate and final results. They conclude that assessment is an issue of adequate funding and available expertise, not a fundamental impossibility. They also argue that the importance of quality assessments is essential for advancing learning and the general credibility of the BDS field.[48]

The debate between Oldsman et al and Downing et al, illustrates why disaggregating the term BDS is useful. Much of the difficulty finding common indicators in BDS is due to the variety of services which fall under that heading. Downing's approach is powerful because it would allow comparisons across a wide range of

[47] Eric Oldsman and Kris Hallberg, "Framework for Evaluating the Impact of Small Enterprise Initiatives," prepared for GTZ and SDC (2001).
[48] Jeanne Downing, Michael Field, and Donald Snodgrass, "Impact Assessment and BDS Market Development: Is a Common Approach and Are Common Indicators Possible?" paper prepared for USAID (2003).

intervention options thus facilitating opportunity cost comparisons. Downing's argument helps explain the shift away from the term "BDS" in 2005; BDS may have fallen out of favor because of poor evidence substantiating its efficacy. Future efforts to promote strategy consulting would be wise to better incorporate quality benefit assessment into their project designs. Better assessment would lead to more effective learning and in turn better interventions as well as enhance the justification for donor funding.

6.2 Measuring Direct Program Costs

Measuring direct program costs can be complicated. Often consulting promotion is only one of several activities in which the implementing agency is engaged. It can be challenging to disaggregate the costs. Measuring the cost of expert time is also tricky. Frequently, programs recruit expert volunteers from the consulting sectors of developed countries. Typically, this is accounted for as an "in kind" donation with a value similar to its value in the developed country. This accounting allows contractors to demonstrate private sector cost sharing, often consider an attractive piece of the program by government donors. However, it is not clear that the value of the consultant's advice is as high in developed countries as it would be at home. Terms of assignment of foreign consultants may be too sporadic and limited in duration to adequately meet the needs of the client, in which case the price of the consulting should be adjusted downwards.

6.3 Measuring Indirect Costs

Interventions need to take account of whether or not they damage the private sector for consulting services. This point inspired the creation of the BDS paradigm. As

seminal documents such as the ILO's Blue Book point out, interventions can hinder the emergence of private sector services by competing at subsidized prices.[49] The EDA India case outlined in **Box 6** faced stiff competition from government providers of knowledge service to leather artisans. The government's program limited the market potential for the private providers of leather advice with whom EDA worked.[50] If the Indian government had fully accounted their costs, they would have included the stunted private sector and perhaps decide against their program.

Chapter 7: Conclusion

Three important questions determine the economic rationality of a strategy consulting intervention in a developing country. First, can consulting services be provided below cost? Second, will the intervention create greater efficiency or promote equity? Third, do the benefits of the intervention outweigh the costs? The process of thinking through these questions leads to four conclusions.

First, donor agencies should commission substantial empirical work to help verify the justification of consulting intervention. Areas for research include (1) the degree to which business cash flows change due to consulting assistance, (2) the costs of consulting services, (3) the commonness or diversity of knowledge and advice demanded by businesses, and (4) the factors contributing to monopoly.

Second, information failure deserves careful attention as a determinant of need for strategy consulting interventions. Information failures are especially likely in the market

[49] ILO, Committee of Donor Agencies for Small Enterprise Development.
[50] Melissa Nussbaum, Ashok Kumar, and Alexandra Miehlbradt.

for consulting because of difficulties assessing the quality of service, determining the probable benefit, and finding suitable transaction partners.

Third, promoting guarantee schemes by consultants is an under explored option. If the primary problem is risk aversion and uncertainty among small businesses, a guarantee scheme could be a key catalyst for getting small businesses the information and advice they need to improve productivity. Donors should explore options for helping consultants to guarantee their services.

Finally, there may be many circumstances which don't call for intervention. The costs of creating the knowledge and advice desired by small businesses may simply not justify the associated benefits. Even in cases where donors know consulting could be efficient, the intervention tools may be more costly than justified. The historic paradigms of business services don't naturally consider the option of *not* intervening. Donor dollars are limited, and practitioners should strive to overcome forces of politics and inertia to be as effective as possible.

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