How to Use Simple Micro-Economic Principles to Guide Your Business Decisions

Good economic decision-making revolves around the objective to maximize benefits while minimizing costs.

BY JOHN V. GUILIANA, DPM, MS

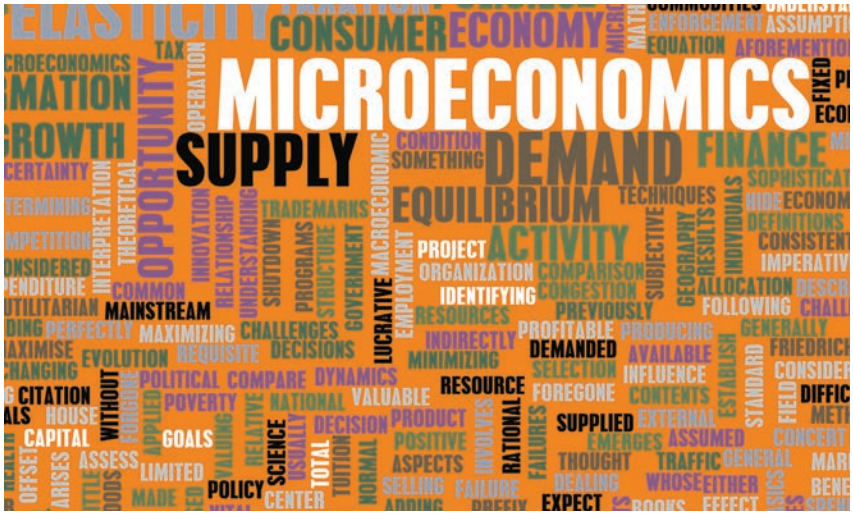
A medical practice is a small or large business the success of which ultimately depends upon good decision-making strategies. Unfortunately, in many practices, the decision-making process is often reactive and not proactive. Small business owners and managers often do not have time to think through the pros and cons and assess the value of their choices. Often, they are forced to make decisions under pressure. Sometimes, it's not the right or best decision.

Various economic principles help managers analyze their decision-making process. Almost everyone engages in economic decision-making at some point, from the billionaire investing in the stock market to the solo medical practice owner signing a contract with an insurance carrier. Basic micro-economic factors almost always come into play.

For managers and owners, the best types of decision-making strategies are ones that are based on a process that can be used over and over again. A thorough understanding of micro-economic principles is also essential to good business decision-making.

Price Versus Cost… They Are Not the Same!

Suppose you buy a gallon of milk for $3. How much did it cost you? You might say, "that's a silly question. It cost $3." But that's simply not true. In microeconomics, there's a difference between price and cost. To prove that price and cost are not the same, consider the following situation: Suppose a patient lives in New York City and routinely pays $85 for uncovered podiatric care. Imagine if that person were told that there's a podiatrist in Boise, Idaho, who can perform the identical services for just $55. Would s(he) start going to the Boise podiatrist? Of course not—because even though the price is cheaper, the cost is greater.



We might think of price as the money that's actually given in exchange for the transfer of ownership. When you purchased that gallon of milk, you simply transferred your ownership of $3. What the milk cost you is a different matter. One way to determine the cost of a gallon of milk is to ask yourself what sacrifice you had to make in order to earn $3 to buy it.

In micro-economic theory, "opportunity cost" is the value of the best alternative foregone, where a choice needs to be made between several mutually exclusive alternatives given limited resources. Assuming the best choice is made, it is the "cost" incurred by not enjoying the benefit that would be had by taking the second best choice available. Opportunity cost plays a crucial part in ensuring that scarce resources, such as staff, are used efficiently. Therefore, opportunity costs are not restricted to just monetary or financial costs. The cost should include the real cost of an alternative forgone, such as lost time, pleasure, or any other benefit that provides "utility".

As economic pressures gain a grip

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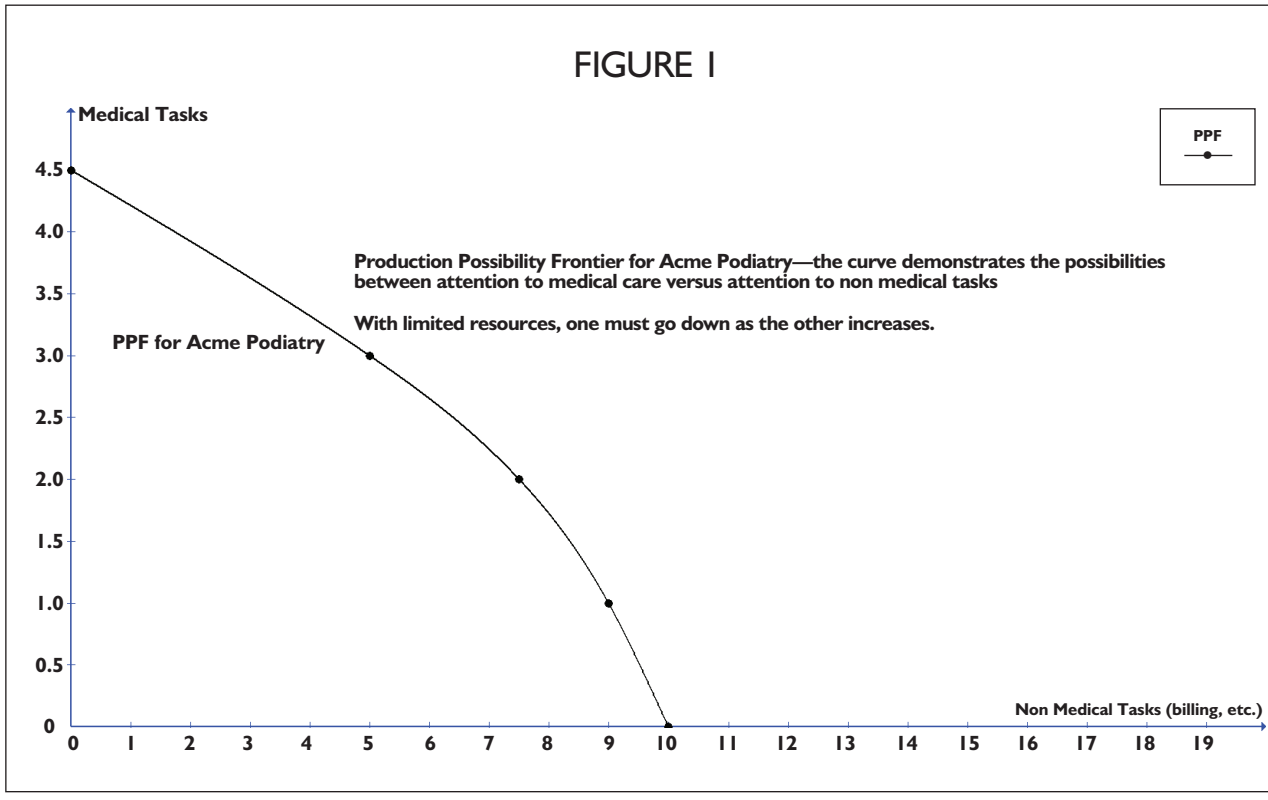

Figure 1: PPF curve for Acme Podiatry

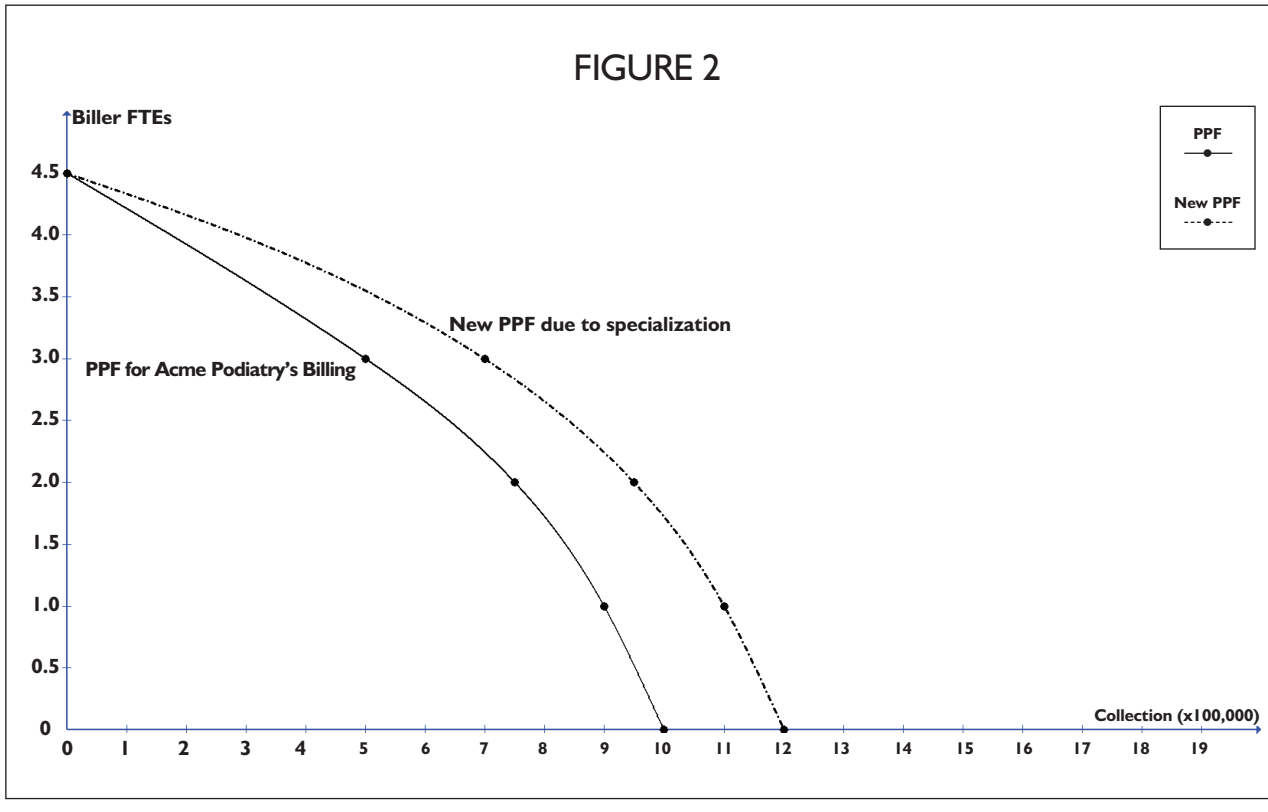

Figure 2: PFF curve after Acme Podiatry decided to outsource their billing to "highly specialized and trained" billers

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on medical practices and stresses their resources, addressing the concept of "opportunity cost" becomes instrumental. In microeconomic terms, an opportunity cost is the cost of an alternative that must be forgone in order to pursue a certain action. In other words, it represents the benefits you could have received by taking an alternative action.

Medicine is rapidly becoming a hybrid of medical care (patient care) and non-medical care (business management, billing, etc.). Unfortunately, unless our resources are unlimited, we cannot devote time to one without sacrificing time devoted to another. That is the applicable opportunity cost.

Economists use what's known as a Production Possibility Frontier (PPF) curve to explore where maximum growth potentials exist.

Figure 1 might be a PPF curve for Acme Podiatry. It demonstrates the "something has to give" concept of opportunity costs.

Now let's consider the true costs associated with the billing process of a practice. According to national averages, a full-time biller costs approximately $35,000 per year (salary, taxes, benefits) and for each $600,000 in collections, a full-time biller is required. So a practice doing $1.2M in collections would typically require 2 full time billers. In these national averages, the costs of a biller related to collections would be 5.8%. But that accounts for only human resource cost. We have to also consider the cost of technology, training, office space, etc. Just as the PPF curve explains the opportunity cost associated with medical care versus non-medical care, there are opportunity costs associated with all of the additional biller expenses just noted. The total cost of each biller could easily climb to over 8%.

What if the billers are not specialized to also handle other tasks within the practice? What if he/she was not trained enough to work as accurately and as fast as possible?

The real objective to maximizing growth is NOT to "move along" a PPF curve and give up one thing to gain another. The real growth comes from "shifting" the PPF curve outward through "specialization", which requires outsourcing.

In the PPF curve, Figure 2, Acme Podiatry decided to outsource their billing to "highly specialized and trained" billers. They did so for barely the cost associated with ONLY their current total billing costs. But this specialization allows for an outward shift of the PPF curve so that at any given point of medical care, collections are much greater. Now that's economic growth! This is why there is a growing trend to outsource many non-medical care business processes (such as billing, IT and HIPAA security, administrative functions, etc.), even lacking the thorough understanding as to

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why. Many practices are intuitively moving in that direction.

Price Versus Value…
They Are NOT the Same Either!

With more of the financial burden of healthcare being placed on the shoulders of our patients in the form of higher co-pays and higher deductibles, it's crucial that we understand the concept of value. More than ever, since the monetary transaction of care is now often "out of pocket", our patients will ultimately make choices based upon value, not just price.

Warren Buffet is quoted as saying "price is what you pay. Value is what you get". Price is defined as the cost of something bought or sold. It's quantified in a dollar amount. Things have a price that may or may not have value. Value is defined as worth or importance. It's the satisfaction obtained from something. It's not referenced in a dollar amount.

Price isn't determined by value; it's determined by the intersection of supply and demand. Value does indeed play into that by determining what the demand for the product actually is. If, for example, you value "Product X" at $10, then you would be willing to pay anything less than $10 for it. If the intersection of supply and demand prices Product X at $5, it doesn't mean that you value it at $5, but it does make it likely that you will buy it. The same is true if the market prices it at $0. It doesn't mean you will place a $0 value on it. It just means it's worth getting at that price, since it's below what you value it at.

For most customers, price by itself is not the key factor when a purchase is being considered. This is because most customers compare the entire market alternatives and do not simply make their purchase decision based solely on a product's price. In essence, when a purchase situation arises, price is only one of several variables customers evaluate when they "mentally" assess a product's overall value.

This price-value proposition plays an important role in how physicians price uncovered services and products, and describes the need to wrap those services around a plan that maximizes the patient's perception of its value.

Other Important Economic Strategies

Decision Trees

Take some of the "emotion" out of your decisions by using a decision tree. A decision tree is a visual graphic flowchart that acts as a decision support tool. It uses a tree-like graph of decisions along with their possible consequences. It forces you to think outside of the box and explore all of the positive and negative consequences of a decision. Businesses often use decision trees to help them make difficult decisions by reducing them to a series of simpler and less emotionally-laden choices. There are many on-line resources to help guide you in using a decision tree.

Budgeting

Creating a budget is crucial to being in control of your finances because it provides a simple way to monitor your expenses. By establishing a budget, you can set targets and goals for achieving a certain level of income, while at the same time, monitor your expenses.

A budget allows management to understand the practice's cash flow and control its costs. It's crucial that you know how much you are spending and on what. A budget allows for limits to be set on costs. By breaking down costs and actually seeing where the money is going, you will likely find that savings can easily be achieved. A budget forces you to become disciplined in examining your expenses and finding ways to stay within your predicted budget at varying levels of income.

Maximizing Value

A fundamental principle of good economic decision-making revolves around the objective to maximize benefits while minimizing costs. This balancing act is referred to as "maximizing value", and it is a skill that takes practice to master.

For medical practices, value maximization decisions may include choosing between name-brand products and generic products, and ordering bulk versus small order sizes. For a practice, value maximization involves finding the lowest-cost suppliers that meet the practice's quality standards, then determining the economic order quantity (EOQ) for each purchase. Economic order quantity represents the ideal amount of a product to order at a time, taking advantage of quantity discounts, while also keeping shipping costs under control. Of course, a good inventory management system is essential to this task.

For larger priced items, it's important to understand how much inventory to keep on hand in order to balance that inventory with your other capital needs. A simple method to achieve this understanding involves computing your *Days in Inventory* for that item.

Days in Inventory will help you gain insight into how much capital you should tie up in the supply of an item. It describes how many days it will take for you to run out of that item at the current rate of its utilization. For example: Suppose your 2014 pneumatic CAM walker cost was $5,000 (and your utilization is fairly stable) and each CAM walker costs $100. In order to keep 30 days of inventory on hand (and not over or under invest):

Days in Inventory = ($ of average supply/annual cost) x 365 days
Or
30 days = ($X / $5,000) X 365 days

You would need to stock approximately $411 worth of CAM Walkers (or 4-5 CAM Walkers at $100 each) and have them on hand to assure a 30-day supply.

Basic micro-economic principles should play an important role in how we view and manage our podiatric practices in the future. Physicians can no longer afford to run their businesses using "gut feelings". Decisions that affect our business processes, decisions to outsource, how we perceive costs, and how our patients perceive value, are all intimately related to these principles. **PM**

Dr. Guiliana is Managing Partner of Collaborative Practice Solutions, LLC, a full-scale podiatric consulting company that owns the innovative product known as Virtual Practice Optimization (VPO). He can be reached at John@collaborativepracticesolutions.com.