Are you Holt Renfrew or Walmart? Applied economics in pricing plastic surgery

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We are often asked how an MBA is of any relevance to a plastic surgeon. Most of our residencies are spent developing the technical and diagnostic skills necessary to perform our craft with proficiency. Residencies usually provide very little training in the fundamentals of running a business. However, as every surgeon knows, the ability to run a business often discriminates between successful and unsuccessful practices. As a result, many surgeons struggle to learn management skills on the fly. With the rebranding of the *Canadian Journal of Plastic Surgery*, we would like to provide tools from business education and scholarship that can help fill this void. We have discovered that bringing business concepts to surgical practice can yield significant benefits and can change the way we structure our daily lives, engage governments and organize finances. In every issue, we will provide a management column as a starting point for discussing the way in which scholarship in business administration can enhance the way we think about practicing plastic surgery. We hope these concepts prove useful and practical for students, residents and practicing surgeons.

ARE YOU CHIC OR ARE YOU CHEAP?

When a resident first graduates and establishes a practice, one of the first questions to arise is, how much should I charge for a specific cosmetic surgery procedure? This is usually followed by a pilgrimage to practicing surgeons in the community to canvas their opinion on the subject. In some cases, surgeons will suggest that the newcomer establish an hourly rate, estimate the time required to perform the surgery, add a buffer and arrive at a surgical fee. The costs of anesthesia, facility and taxes should be added and charged to the patient. Potentially, an established surgeon will be sufficiently kind as to furnish the rookie with his own price list. In most cases, this advice will be predicated on some combination of the cost of surgery and the amount the surgeon would like to bill for his time. It is very rare that surgeons base this advice on market analysis, applied economics and strategic considerations.

As it turns out, the issue of pricing is a robust area of economic research. The basis of much of this scholarship stems from a dichotomy introduced by Michael Porter in 1980. In that year, he published a landmark book called *Competitive Strategy* (1). He suggested that there are two primary avenues by which successful firms compete: overall cost leadership and differentiation.

In overall cost leadership, firms compete to be the lowest cost provider of a specific service. This type of competition tends to occur in markets where services are relatively homogenous and difficult to distinguish from one another. To take the most extreme example, consider the market for paper clips. Economists refer to these markets as ‘perfectly competitive’. From a consumer’s perspective, all paper clips are essentially equal. Therefore, when a consumer chooses to buy paper clips, he doesn’t really care about anything other than price. The firm that can provide paper clips at the cheapest price is the firm that will get his business. A small change in price has a very significant impact on the volume of paper clip sales. Economists refer to such markets as having a high price elasticity of demand. This puts a huge amount of pressure on a firm to be the lowest cost provider. The firm that can sell at the lowest price will win.

Walmart is the perfect example of such a firm; people shop at Walmart because they are able to purchase products at the lowest price possible. Walmart earns a very small profit on each individual sale (they even lose money on some sales, but that’s a different story), however, it earns huge profits by having such a large volume of sales. The low-cost provider tends to make money on sales volume rather than on profit per individual sale. To win the battle in a war of cost leadership, the successful business will have a higher volume and a lower price.

The other successful strategy offered by Porter is differentiation. This strategy predominates in markets that are heterogeneous. In such markets, firms attempt to distinguish their products from their competitors. They suggest that no specific substitute is available to replace the good or service that is being offered. To take the most extreme example of this situation, consider the market for diamonds. DeBeers has spent an enormous amount of time and capital promulgating the idea that there are no adequate substitutes for diamonds. As a consequence, the price of diamonds is very high. More importantly, the profit margin on the sale of each individual diamond is also extremely high. Changing the price of diamonds has very little impact on the volume of sales. Economists refer to such a market as having a very low price elasticity of demand. People tend to keep buying diamonds regardless of what they cost because they simply must have diamonds. No other gem will do.

Porter (1) recognized that in markets where products are not easily substituted for one another, firms compete on the basis of quality. In such a market, firms try to differentiate themselves from their competitors on the basis of quality. Holt Renfrew is a good example of such a strategy. There are many places where people can buy clothing. Holt Renfrew carries premium brands at a very high price. If consumers believed that they could get the same kind of clothing at another store, they would never pay the high costs charged by Holt Renfrew. The secret to their success is in establishing a quality differential. People are willing to spend more money on clothing because they perceive a vast benefit in terms of quality or status. The price of the clothing becomes secondary to the benefit gained from having something that is better than any other alternative. In this type of market, firms may have lower sales volume but will earn high profit on each individual sale. The winner in the differentiator’s market is the firm that is perceived as being the best, not necessarily the cheapest.

SO HOW DOES THIS APPLY TO PLASTIC SURGERY?

We’re hoping that by now you are thinking about how to classify the services you provide. Of course, the examples above are more extreme; however, a similar approach can be used in our field. Consider that in California (USA), the price of liposuction has decreased by 75% over the past decade. Similarly, vigorous competition exists in the markets for injectables, skin resurfacing and skin products. Such services are most easily conceptualized as being in the category of overall cost leadership. For such services, surgeons should consider that patients may seek the cheapest alternative in the community. As a result, the primary method for succeeding will be based on high volume. Alternatively, consider rhinoplasty, rhytidectomy and blepharoplasty. While some competitive pressures have eroded the profit margin on

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these procedures, this has not occurred to the same degree. We submit that this is due to the fact that, for these procedures, patients often discriminate more carefully on the basis of quality and expertise. As a result, such services tend to be more broadly perceived as heterogeneous and, therefore, compete in a differentiator's market. These consumers are less sensitive to cost and more concerned with quality.

What is a new plastic surgeon to do? It's always a good idea to understand the prices charged by other surgeons in your community. However, this analysis ignores the value placed by patients on such services. Every community will have a different economic environment. While services may be perceived as substitutes in California, the same may not be true in Saskatoon (Saskatchewan). Furthermore, while patients may be willing to place a premium on a highly differentiated product in Vancouver (British Columbia), they may not be willing to do the same in Ottawa (Ontario). This requires a more sophisticated market-based approach and knowledge of one's individual circumstances. Such analyses of markets offer an interesting area for future research.

As a new surgeon starting practice, the question of pricing is critical. It may establish the cost and revenue structure of the practice for many years. It is important to consider the sources of revenue and potential for increasing profit. As you consider your revenue structure, it might be worthwhile to evaluate each service you provide and ask yourself, would I get this at Walmart or would I buy this at Holt Renfrew? That answer could be the first step in establishing a successful practice

REFERENCE

1. Porter M. Competitive Strategy: Techniques for Analyzing Industries and Competitors. New York: The Free Press, 1980.