STRATEGIC DECISION-MAKING IN HEALTHCARE ORGANIZATIONS: IT'S TIME TO GET SERIOUS[1]

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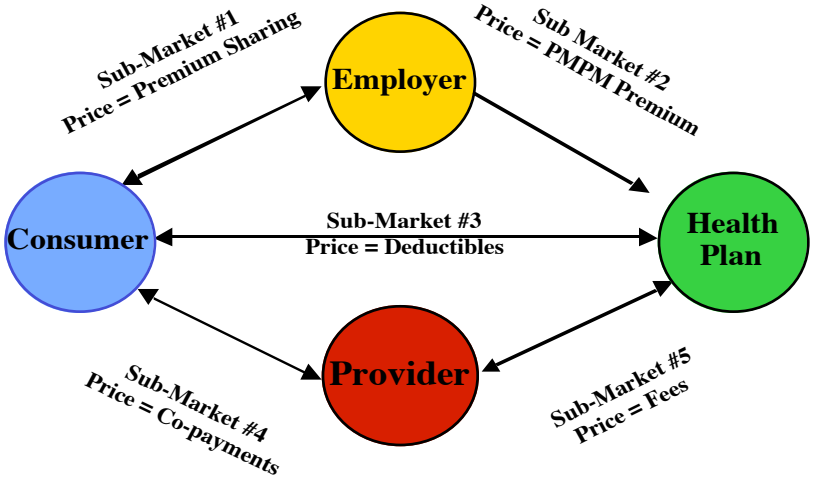
During the next two decades, healthcare organizations will confront a variety of environmental and competitive demands requiring new forms of strategic thinking. For example, the recent entrance of "baby boomers" into the 50-55 year age group suggests that, without some significant changes in lifestyles, public health programs, or healthcare delivery patterns, there will be exponentially increasing inpatient costs. In part, this is because the kinds of conditions that are likely to present themselves (such as cancer and heart disease) are not easily treated in an outpatient setting.

These environmental demands take place in a marketplace that is not well described in any economics textbook. As Exhibit 1 shows, there are four actors: Person A (a patient) who receives services from or at the behest of Person B (a hospital, clinic, or physician), whose fees are paid (or costs reimbursed) by Person C (a health plan or other insurer), who receives insurance premiums from Person D (an employer).

Exhibit 1. The Market Problem



Each of the five "submarkets" in Exhibit 1 has a different pricing unit. The most complex is in the submarket between insurers and providers, where the options include per diem payments, DRG payments, bundled prices (physician and hospital) for a DRG, discounted fee for service, and sometimes subcapitation. Moreover, in each submarket, the seller's price will have an impact on the purchaser's buying behavior, resulting in decisions that interact with other aspects of the healthcare system. An example of these interactions was seen some years ago, when the introduction of a $1 copayment for California's MediCal (indigent) patients led to a substantial reduction in their use of primary care services. Unfortunately, some of these same patients were hospitalized several months later with conditions that could have been avoided had they been treated with timely primary care. The result was an increase in *total* MediCal expenditures.[2]

The mixture of environmental demands, market forces, and system interactions means that all healthcare organizations, but especially hospitals, must think more carefully than previously about the environmental threats and opportunities they face. They then must couple that assessment with an analysis of their capacity to develop appropriate strategic responses.

ASSESSING ENVIRONMENTAL DEMANDS

Strategy-formulation frequently includes a "SWOT" analysis, or an assessment of internal strengths and weaknesses (SW) combined with environmental opportunities and threats (OT). However, a SWOT analysis can never consider *real* organizational strengths and weaknesses or *real* environmental opportunities and threats, since these are never known. Instead, senior managers focus only on *perceived* strengths, weaknesses, opportunities and

[2] Roemer, M, 1975. "Copayment for Primary Care: Pennywise and Pound Foolish," *Medical Care,* June

threats as filtered through their own lenses and those of middle managers, physicians, nurses, and others in the organization. These filtered perspectives prevent senior management from seeing the real SWOT, thereby creating a potential for sub-optimal strategic decisions.

Novo Industri, a manufacturer of porcine and bovine insulin, illustrates this distinction. Novo had a strategy that included substantial resources devoted to research and development focused on reducing the impurities in animal-based insulin. The strategy also included the development of a complex logistical network that assured a constant flow of the pig and cow pancreases to meet the demand for Novo's product (10,000 pounds of animal pancreases were needed for one pound of crystallized insulin). Novo had an unmatched capability to provide consumers with the purist possible porcine and bovine insulin.

This strategy was disrupted when Eli Lilly introduced genetically-engineered (GE) insulin, a product that not only had no impurities whatsoever but was less expensive to produce than animal insulin. Either Novo's senior managers did not see the impending disruptive technology, or, more likely, they believed that GE insulin would not have a significant impact—a clear illustration of the difference between the perceived and real environments.

In the hospital sector, these disruptions have been somewhat more subtle but nonetheless powerful. Laser eye surgery has emerged as a substitute for prescription lenses, cardiac stents have been used instead of open heart surgery, laproscopic surgery has replaced more traditional surgery, magnetic resonance imaging has taken the place of traditional x-rays, and renal transplants have obviated the need for renal dialysis. The list is long.

The impact of these disruptions can be significant. For example, digital imaging, which allows radiological films to be sent anywhere in the world to be read, has increased the power of managed care plans and other buyers of radiologists' services, and can affect a radiology department's strategy. In fact, a few years ago, a Florida managed care organization informed its radiologists that it no longer would need their services. It had reached an agreement with a radiology group at UCLA to have its films read in California.

CLOSING THE GAP BETWEEN PERCEIVED AND REAL

There are four techniques that organizations can use to close the gap between the perceived and real environments. In some organizations, these techniques are essential aspects of the strategy formulation process.

Technique #1. Generate Conflict

Properly managed, conflict can provide considerable information about the organization's environment. A hospital concerned about, say, the impact of a proposed musculo-skeletal center on its overall operations might dedicate an afternoon or longer to a discussion among the leadership of several departments about ways the proposed center will affect matters such as operating room demand, nurse and other staffing needs, purchasing logistics, and the like. A variety of contrasting views no doubt would arise and need to be resolved, all of which can contribute to a more successful implementation effort.

Technique #2. Encourage Employees to Question Existing Rules and Assumptions

When a hospital includes a member of the housekeeping staff or a transport worker on a process redesign task force, the results can be both surprising and dramatic. In some hospitals, these lower level workers have a deeper understanding than their superiors of the environment that affects their jobs, and can suggest effective ways to address those issues.

Technique #3. Develop a Learning Culture

An off-site workshop to discuss the difficulties one department encountered in developing and implementing a clinical pathway no doubt could be immensely useful to other departments faced with a similar task. For this to happen, the culture needs to encourage it, and the organization needs to institute a process for the sharing of ideas.

Technique #4. Distinguish Between Available Resources and Patient Needs

In one hospital where a study was underway to improve the efficiency of the admissions office, a member of the task force questioned whether the office was really needed. After some weeks of study and analysis, the hos-

pital decided to eliminate its admissions office entirely—it found that the admissions *process* could take place without the presence of an admissions *office*.

More generally, hospitals need to think carefully about the mix of services they provide to patients, the cost of providing each of those services, and whether the services are really needed for high quality care. Consider, for example, the two emergency-room treatment patterns shown in Exhibit 2. As it demonstrates, the avoidance of unneeded resources (an inpatient admission in this case) allowed the hospital to achieve the desired result (the effective treatment of a patient) at a much lower cost.

Exhibit 2. Example of New Inpatient Utilization Pattern

48 YEAR OLD PRESENTING WITH ATYPICAL CHEST PAIN, POSITIVE SMOKING AND FAMILY HISTORY , AND NORMAL EKG

CURRENT PATTERN		OPTIONAL PATTERN	
Admit to Telemetry ALOS = 2.2 days	$2,800	Admit to Observation Unit ALOS = 23 hours	$1,000
Daily EKG x 3	$225	EKG x 2	$150
Enzymes and Full Bloods	$175	Enzymes and Limited Bloods	$75
Cardiology Consult	$150	Cardiology Consult	$150
Echo	$350	Echo	$350
Thallium Stress Test	$450	Non-Thallium Stress Test	$125
TOTAL COST	$4,150	TOTAL COST	$1,850

AT AN INCIDENCE RATE OF 5/1000, THE PURCHASER WOULD SAVE $3.5 MILLION ANNUALLY

BEYOND CLOSING THE GAP

Once an organization believes it has a good understanding of its *real* strengths and weaknesses, and its *real* environmental threats and opportunities, it is prepared to formulate a strategy. In part, the quality of the resulting strategy can be assessed in terms of the "tradeoffs" it makes. That is, a strategy requires an organization to decide what it is *not* going to be as well as what it intends to be.

The Tradeoff Process

There are three broad dimensions where organizations make tradeoffs: service or program variety, customer needs, and customer access. Two well-known non-health organizations illustrate these tradeoffs. Ikea, a company that sells unassembled furniture, focuses on many customer needs, but offers limited access and has a limited range of products. Jiffy Lube, by contrast, has made its tradeoffs by focusing on broad access to some very limited services, meeting very few customer needs.

Most healthcare organizations have not made these sorts of tradeoffs, preferring instead to attempt to be all things to all patients (or all potential patients). Nothing could be more strategically misguided. To thrive in the 21st century, healthcare organizations must begin to consider which services and programs they wish to emphasize, for which kinds of patients, and in which locals. They then will need to eliminate those programs and avoid those patients that do not fit into the chosen focus.

Making strategic tradeoffs does not require hospitals to become "focused factories," i.e., institutions offering only one service to many patients.[3] Shouldice Hospital, in Canada, is an example of such as hospital. Its only service is a hernia operation. It draws patients from long distances for its cost-effective and high-quality care, and, in so doing, has become the epitome of the focused factory. Organizations such as M.D. Anderson Cancer Center, Cincinnati Children's Hospital, Massachusetts Eye and Ear Infirmary, and New England Baptist Hospital—by focusing on patients with particular disease conditions (e.g., cancer), or particular characteristics (e.g., children), or who have problems with particular organs (e.g., eyes, ears, nose, and throat), or who need certain kinds of surgical procedures (e.g., orthopedics)—have made similar tradeoff decisions, although none quite as specific as Shouldice.

[3] Herzlinger, R., 1997. *Market-Driven Health Care,* New York, Perseus Books

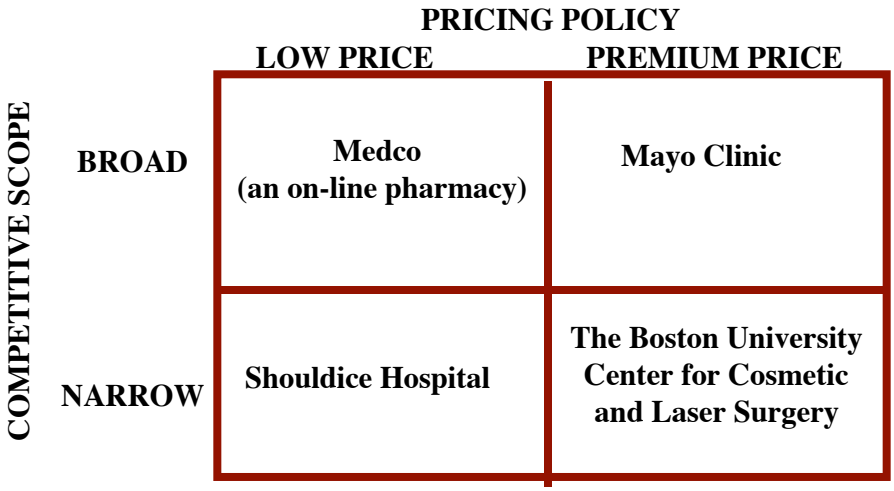
A Framework for Strategic Tradeoffs. Strategic tradeoffs can be assessed in terms of competitive scope (broad versus narrow) and pricing policy (low price versus premium price). The goal of organizations with a low-price strategy is to deliver a product of acceptable quality at a lower price than its competitors. By contrast, organizations with a premium-price strategy select narrow market segments with unusual needs, and offer them products and/or services that are widely acknowledged as superior on at least one dimension.

There are multiple dimensions that justify a premium. In the for-profit world, they include durability (e.g., Energizer batteries), speed (Federal Express), variety (Amazon.com), ease of use (Macintosh), image (Mont Blanc pens), overall experience (Starbucks), safety (Volvo), exclusivity (American Express Black card), and no doubt many others. In general, the greater the differentiation, the wider the potential price gap between the organization and its competitors.

As Exhibit 3 illustrates, some healthcare organizations have made tradeoffs along these two dimensions, but examples are difficult to find. Yet, these sorts of tradeoffs are essential for long term financially viability.

Making tradeoffs requires courage, in large part because it means denying service to some existing patients or telling former patients to go elsewhere the next time they need care. Yet, doing so can have powerful consequences. A telling example is Lan and Spar, a small Danish bank. After senior management had decided to focus its strategy on white collar workers, the bank sent letters to its corporate customers (who were not part of the new strategy) asking them to move their accounts to another bank—a courageous step, indeed. Lan and Spar is now the most profitable bank in Denmark, in large part because of its highly focused strategy.[4]

Exhibit 3. Strategic Positioning in the Healthcare Industry



In the healthcare sector, with the exception of most hospitals, the past several years have seen an increase in premium-priced services. One need only read the ads in any magazine that caters to people over 50 to see offerings for cosmetic surgery and liposuction clinics, laser hair and cellulite removal centers, hair restoration clinics, and the like—all premium priced services. To support this strategy, many cosmetic surgery centers have focused on patients (e.g., actors or members of the "jet set") who have few price constraints. In some states, "boutique" physician group practices now cater to individuals who are willing to pay a price premium for more personalized care and shorter appointment queues.

Mayo Clinic is a good example. Mayo focuses on patients (especially international patients) who are not constrained by insurance limits on payments, and it offers what most observers consider to be a superior, well coordinated set of services.

Some hospitals have moved slightly in this direction by offering supplemental services for which the patient pays out-of-pocket, such as private rooms or gourmet meal service, but, in general, most hospitals are stuck in the middle. They are constrained by third-party or governmental payment rates (which usually make them low-price

[4] Markides, C. C., 2000. *All the Right Moves,* Boston, Harvard Business School Press

providers) and yet they must contend with medical staffs that demand premium-priced resources. For example, some orthopedic surgeons, largely due to personal preference, use comparatively expensive joint replacement devices when less expensive devices would suffice. Some hospitals allow physicians to admit their patients with little or no advance notice, even when the need for hospitalization is not urgent. One result is nursing-coverage demands that require the use of expensive agency nurses. Other hospitals remain at low occupancy during weekends and holidays because physicians do not want to work during these time periods, or because potential patients wish to be at home with their families. Still others succumb to physician demands for cutting-edge technology when less-expensive technology would do an acceptable job without compromising quality.

Assessing the Quality of an Organization's Strategy

There are three criteria that senior managers can use to assess the quality of their chosen strategy. First, the strategy must be consistent with the factors that are critical to success in their environment. These factors will differ from one state to the next, depending on a variety of legal and payment requirements and constraints. There also will be different factors for different hospitals in a given state. Certainly, the environment of a large urban teaching hospital in New York City is considerably different from that of a small rural community hospital in Florida.

Second, the organization's strategy must be capable of adapting to unanticipated circumstances or changes in its environment. Here, an organization must tread carefully between being capricious and whimsical, on the one hand, and rigid despite overwhelming evidence of a need for change, on the other. For example, despite overwhelming evidence of an aging population and the demands they will bring, many hospitals have not even begun to invest in geriatric programs or other infrastructure needed to care for the elderly. Denying the impending impact of this demographic "bubble" portends the same sort of calamity that befell Polaroid and Kodak when they denied the impending impact of digital photography.

Finally, and most importantly, the strategy must be accompanied by a robust and internally consistent set of operational activities. An "activity set"[5] not only must fit with the organization's critical success factors, but it must be difficult for competitors to imitate. This combination assists the organization to sustain its programs and services against efforts by competitors to capture some of its market share.

Creating an Activity Set

An activity set comprises those structures, systems, and processes that are consistent with the organization's strategy, and that assist the organization to attain superior performance. It includes operational policies and procedures, information systems, incentive and reward systems, conflict management processes, lines of authority, the capital budgeting process, and operational budgeting and reporting systems.

A good activity set is so tightly linked that it is all but impossible to copy a part of it. A competitor must either copy the set in its entirety or not do so at all. An airline wishing to compete with Southwest Airlines, for example, must have an activity set that includes an absence of first class travel, meal service, and assigned seats. A competitor also must limit baggage handling, use secondary airports, and have a fleet of identical aircraft. Combined, these and several other activities contribute to Southwest's rapid gate-turnaround times.

Without the *entire* collection of activities for *all* of its flights, an airline cannot achieve the rapid gate turnaround time that allows Southwest to keep its planes in the air more of the time than its competitors and hence use fewer aircraft for the same number of passenger miles. Southwest's industry-beating return on assets is due in no small way to its need for fewer fixed assets (airplanes) per dollar of revenue than its competitors.

It would appear that many hospitals could make better strategic tradeoffs than they have to date by recognizing that they function in the low-price column of Exhibit 3, and therefore, like Southwest, need to design an appropriate activity set. Although few hospitals have done this, imagine the competitive advantage that a hospital could have if it linked its strategy of low-cost inpatient care services with an activity set comprising: a capital budgeting process that ensures investments in assets that lower operating costs, rather than increasing the supply of cutting-edge technology; operational budgeting and procurement processes that assure the use of standardized surgical devices; an information system that includes an electronic medical record permitting the rapid retrieval of diagnostic and treatment information; an operational policy that requires non-urgent care admissions to be scheduled with

[5] For a discussion of activity sets and some detailed illustrations, see Porter, M., 1996. "What is Strategy," *Harvard Business Review*

several weeks advance notice;[6] another operational policy that requires patients scheduled for orthopedic surgery to begin their rehabilitation care several weeks prior to admission so as to shorten their lengths of stay; a home care program that minimizes the number of readmissions following earlier-than-average discharges; and so forth.

THE FUTURE

Many healthcare organizations have used their nonprofit status and the importance of their missions as excuses to avoid making difficult strategic tradeoffs. Indeed, some of them have been critical of organizations that have made tradeoffs. For-profit hospitals that are selective in the patients they serve, or entities such as cosmetic surgery centers, boutique physician practices, freestanding dialysis clinics, and the like, all have been looked on with disdain. Yet, the essence of strategy rests in these sorts of tradeoffs.

Strategic tradeoffs do not need to be mercenary. Nor do they imply lower quality care or a compromise in the nonprofit mission. Rather, they address the reality that no organization can be all things to all people. In short, by thinking more creatively in the future than they have in the past, healthcare organizations, and especially hospitals, can begin to make the sorts of tradeoffs that will allow them to choose a strategic position. They then can design an activity set to support that position—one that will allow them to be financially viable while simultaneously achieving and sustaining superior programmatic performance.

[6] This idea is not as far-fetched as it may seem. Several years ago, the Massachusetts Eye and Ear Infirmary developed an admission-scheduling system that required several weeks advance notice for non-urgent procedures. The result was that the hospital could plan admissions in such a way as to function with a full-time nursing staff that used little overtime, required minimal part-time or agency nurses, and was fully occupied during each day.