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# Health Care Cost Growth: Trends, Sources, Strategies, and Feedback Loops

By Len Nichols

**T**his chapter discusses reasons for the rapid increases in health care costs. Even though hospital services are by far the largest segment of U.S. health care spending, expenditures on other services, such as physicians' services and prescription drugs have increased at a faster rate. The cost growth is attributed to medical price inflation, the growth in volume of services, and the growth in intensity of services. Most expenditures are driven, not by inflating medical prices, but rather by the increasing volume and intensity of services. In the next decade, the rate of cost growth is expected to accelerate.

In 2001, health care spending grew by 10% per person, the first double-digit increase in more than a decade.<sup>1</sup> Experts on national health care costs are forecasting 7% to 9% annual growth in health insurance premiums for the next decade. Across the nation, states are struggling to understand what is behind escalating health care costs and how best to contain them. This chapter examines the major cost drivers in the health care system, how they are changing.

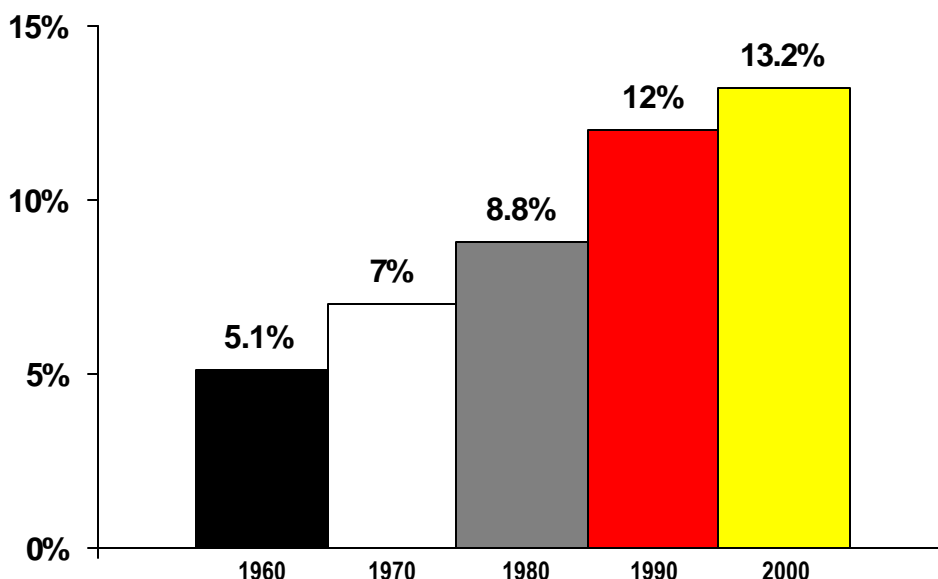
## What Are the Impacts of the Growth in Health Care Costs?

**Health care spending comprises 14% of U.S. Gross Domestic Product (GDP).**

For the past forty years, health care spending has become a larger and larger proportion of the U.S. Gross Domestic Product (GDP; see Figure 1). In 1960, the U.S. spent 5% of its GDP on health care. As of 2000, that proportion had grown to 14%, or nearly three times what it was forty years ago.

This growth rate marks a profound change in the role health care plays in Americans' lives. The good news about this shift is that it reflects the marked advances in health technologies that allow more people to live longer, healthier lives. On the other hand, rising costs for health services mean that our society must sacrifice an increasingly greater share of other goods and services in order to pay for health care.

**Figure 1. Health Care Costs Are an Increasing Percentage of Gross Domestic Product**



Source: CMS, National Health Accounts Data

**The costs of health care for the uninsured.** Access to insurance and addressing the needs of the uninsured are also strongly affected by overall health care cost growth. Historically, the health care costs of people without insurance have been absorbed by consumers who have health insurance—who are charged more than their care actually costs—and by taxpayers as governments subsidize these safety-net providers directly. With continued cost growth, however, it is becoming more difficult to hide these costs and more challenging to pay for them.

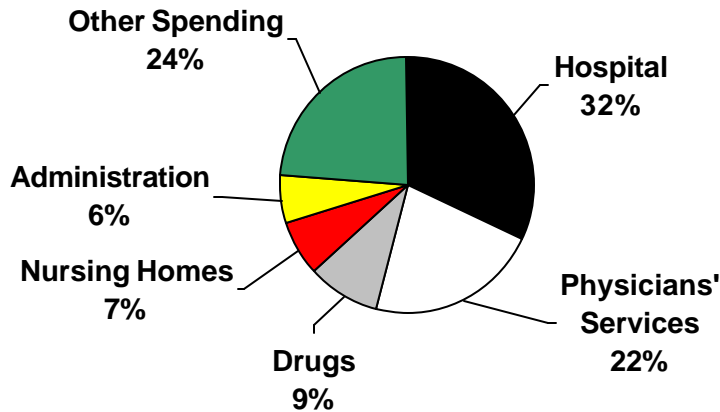
**Health care costs have grown faster than the U.S. economy.** Because health care costs have risen faster than overall U.S. economic growth, a growing fraction of the workforce is unable to pay for health care without some kind of subsidy. When premiums rise faster than wages, this translates into a *relative* price increase for health insurance compared with other consumer goods. Even if this relative price change is small in any single year, it can still cause a larger proportion of workers to decline health insurance—a trend that has emerged over the past 15 years.

**Hospital services are by far the largest segment of health care spending.**

### What Is Happening to Health Care Costs Over Time?

**Hospitals get the largest share of health care spending.** To understand how costs are changing over time, it is useful to examine what our health care dollars buy (see Figure 2). Hospital services are by far the largest segment of U.S. health care spending. Yet, while hospitals are still the largest recipient of health care dollars, expenditures on other services have increased at a faster rate. Therefore, hospital costs are now a smaller piece of the total health care spending pie than in the past. At the same time, physicians' services and prescription drugs are becoming increasingly larger proportions of total health care costs. Despite the attention paid in recent years to accelerating prescription drug costs, they still account for only 10% of total health care expenditures.

**Figure 2. What Do Our Health Care Dollars Buy?  
How Are U.S. Health Care Dollars Spent?**



Source: CMS, 2002. Calendar year 2000 data

If we were to break down patterns of cost growth, three major categories emerge:

- 1) Medical price inflation;
- 2) Growth in volume of services; and
- 3) Growth in intensity of services.

Medical prices rise in relative terms when the price per unit of the service—say of an office visit or a particular surgical procedure—rises faster than other prices. While this is important, most expenditure growth is actually driven by increasing volume and intensity of services (i.e., more services or more complex services are being delivered during an office visit or during surgery).

**Technology leads to increases in volume and intensity of services.** One of the complex aspects of cost growth is that the lines between these categories are often blurred. For example, in the research community, there is widespread agreement that the most important source of cost growth, accounting for more than 50% of the increase, is related to technological advances.

The reason technology has played such a major role in cost growth is that it impacts both the volume and intensity of services. Complex and resource-intensive procedures require providers to charge higher prices. Meanwhile, other less-invasive technological advances that could lower prices can be used with a higher number of patients, thus still increasing overall costs. For example, 11% of Medicare patients with a heart attack in 1984 received surgical treatment. Ten years later, this number had increased to 47%. While there is no question that this intervention helped many heart attack patients, that 10-year span saw a spending increase of almost 60% for each heart attack case.

***Most expenditure growth is actually driven by increasing volume and intensity of services.***

**Fewer in-patients, more services.** To further illustrate the overlapping of volume and intensity in services, consider, for example, that the number of days people spend as hospital in-patients has fallen by more than half since 1980. Yet, over this same time period, the total hospital costs per person have risen by almost 60%, because patients are receiving more intensive services each day they are in the hospital. Of course, breaking cost growth down this way may be oversimplified because it does not take into account potential increases in productivity.

Technological developments result in other costs as well. In addition to higher costs for services, many treatments require other complementary services. For example, before a patient has bypass surgery, he or she must receive cardiac catheterization. Post-surgical rehabilitation treatment also creates added costs.

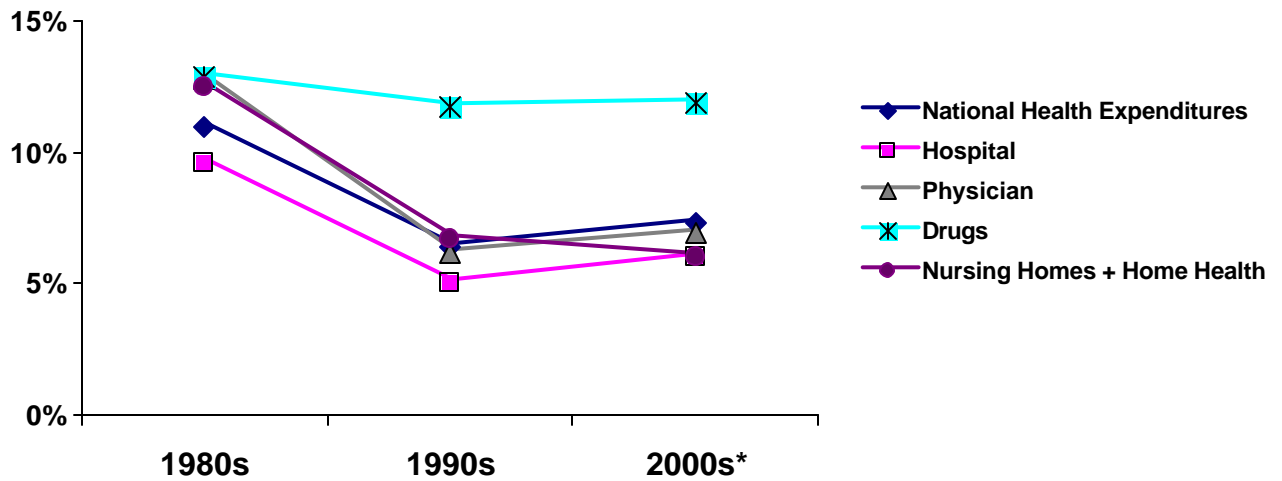
Other, more specific sources of health care cost growth currently being discussed include:

- ❖ **An aging population.** Our population is aging, and health care costs increase with age, so many people assume that aging per se is a major driver of health care cost growth. Recent research suggests that is not the case: in 2001, population aging contributed an estimated 0.7 percentage points, or less than 10% of the total increase in per capita health care spending for people under 65.<sup>2</sup>
- ❖ **The spread of more comprehensive insurance.** More comprehensive insurance provides pooled purchasing power so that more people can afford new technology and more complex services. This, in subtle ways, makes for continued cost growth, as well as expanded access to these services over time.
- ❖ **The rise of defensive medicine.** Providers, especially physicians, fear malpractice claims and may provide more diagnostic and in some cases therapeutic services just to reduce the risk of being held liable for negligence in a medical injury lawsuit. This has proven hard to document, but is a real phenomenon in many providers' minds.

### **Where Are Increasing Health Care Costs Coming From Over Time?**

Growth in the cost of all health care components declined in the 1990s, although prescription drug costs showed the least decline (see Figure 3). Yet, there is evidence that these apparent declines may be a “one-time shot” caused by the transition to managed care. The management of health care use and new price discounts resulting from managed care are real efficiencies in the health care system. Yet in the next decade, each component of health care cost is expected to grow.

**Figure 3. Growth in Costs Declined in the 1990s, with the Smallest Declines in Prescription Drugs**



Source: Author's calculations, annual compound growth rate by decade, using CMS National Health Account data, 2002

\*Projected

**Hospital spending is the key driver of cost growth.** Increased hospital spending continues to stand out as the recent key driver of growth in overall spending. The cost of hospital in-patient services grew 7.1% in 2001, which is nearly three times the 2000 increase (2.5%). At the same time, hospital out-patient services also grew at a dramatic rate, climbing 16.3% in 2001. Together, in-patient and out-patient hospital services accounted for more than half of total spending increases in 2001.<sup>3</sup>

**Prescription drug costs are high, but comprise a small share of spending.** Increases in prescription drug spending continue to be high, but studies show that the growth rate for 2001 slowed slightly for the second year in a row. In 2001, prescription drug spending grew by 13.8%, down from 14.5% in 2000.<sup>4</sup> In real terms, prescription drugs continue to rise faster than any other segment. Relatively speaking, however, their role in overall health spending has less of an impact than rising hospital costs.

*Prescription drug costs continue to rise faster than any other segment of health care costs.*

### What Is Driving Health Care Costs Now?

The causes of current rising health care costs can be broken down into four major factors:

- ❖ **Managed care loosening.** Fearful of consumer backlash, managed care plans have reduced restrictions on access to specialists and other services. Formerly, managed care plans tightly controlled access to health care.
- ❖ **Provider capacity constraints.** Mounting evidence indicates that there are capacity constraints on the current health care system. Patients are reporting more frequent delays in receiving care and more time when their needs are not met. Physicians are working longer hours and are less likely to take new patients. Hospitals are reporting nursing shortages

***It is likely that states will need to address health care cost issues without substantial assistance from the federal government.***

which impact both emergency rooms and regular beds. All of this lets providers know they can raise prices.

- ❖ **Provider consolidation and ‘pushback’ for higher payment rates.** Providers have increased their market leverage vis-à-vis health plans. In addition to recent hospital capacity shortages, consumers’ demands for broad networks in the health care system and consolidation in the hospital industry have resulted in a shift of power between hospitals and health plans. Hospital providers are now in a position to be able to demand higher payment rates to remain in existing health plans. This “push back” by hospitals is, in part, a backlash effort to reverse the effect of agreeing to discounted payments during the mid-1990s.
- ❖ **Direct-to-consumer advertisements for prescription drugs.** The proliferation of direct-to consumer advertisements from drug companies also plays a role in driving up the costs of overall health care. These advertisements include magazine, newspaper, radio, and TV promotions targeted at consumers. Between 1995 and 1998 alone, promotional spending of this type more than tripled, from \$400 million to \$1.3 billion.<sup>5</sup> These ad costs are passed on to consumers in the form of higher prices for advertised medications. Along with other information that is more readily available in ‘unfiltered’ forms, advertising has also led to an increase in the number of patients who make specific requests of their providers. Physicians worried about patient satisfaction are increasingly reluctant to send patients away “empty handed.”

## **How Are Stakeholders Responding to Rising Costs?**

### **Employers**

Employers are responding to rising health care costs in two ways. Many are attempting to increase employee cost-sharing by raising employee premiums and out-of-pocket payments at the time of service, and less frequently, are reducing benefits. However, employers also are trying to increase employee choice.

### **States**

States’ responses to rising costs are complex. In a time of budget shortfalls, states are trying to make the most effective cuts possible without hurting their citizens. As a part of this effort, many states are reducing benefits, raising eligibility requirements, and reducing payments to providers. Given current fiscal conditions, it is likely that states will need to address health care cost issues in the future without substantial assistance from the federal government.

### **Federal Government**

Efforts to control costs at the federal level include granting Medicaid waivers to states and discussions of long-term reform to control health care costs. Many policy options are currently on the table. In the future, the federal government could take measures to insulate states from the effects of recessions. Similar to unemployment compensation, the U.S. also could have cyclical federal matching payments to offset the effects of economic downturn on states.

## Conclusion

Despite efforts by stakeholders at all levels of the health care system, no single or simple solution exists. Policymakers, health care providers, and citizens alike wrestle with how best to contain health care costs while continuing existing levels of health care coverage for those Americans who are covered today, along with the 41 million Americans who are uninsured.

*This paper is based on the following talks given by Dr. Nichols:*

“Health Care Cost Growth: Sources and Prospects.” National Conference of State Legislatures. July 26, 2002.

“Health Care Cost Growth: Trends, Sources, Strategies and Feedback Loops.” October 24, 2002. National Institute for Health Policy.

*Some material in this paper is also drawn from the following published articles:*

Nichols, Len M. (June 2002). *Can defined contribution health insurance reduce cost growth?* Employee Benefit Research Institute Issue Brief 246. Washington, DC: Author.

Pauly, Mark V., & Nichols, Len M. (October 23, 2002). The nongroup health insurance market: Short on facts, long on opinions and policy disputes. *Health Affairs* Web Exclusive downloaded from: [http://www.healthaffairs.org/WebExclusives/Nongrp\\_TOC.htm](http://www.healthaffairs.org/WebExclusives/Nongrp_TOC.htm)

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<sup>2</sup>Strunk, B., & Ginsburg, P. (September 2002). *Aging plays limited role in health care cost trends*. Center for Studying Health Systems Change, Data Bulletin #23. Downloaded from: <http://www.hschange.org/CONTENT/473>.

<sup>3</sup>Strunk et al., 2002.

<sup>4</sup>Ibid.

<sup>5</sup>Kreling, D. H., Mott, D. A., & Widerholt, J. B. (2001). Why are prescription drug costs rising? In Bogenschneider, K., & Mills, J. (Eds.) *Rising prescription drug costs: Reasons, needs and policy responses* (pp. 1-13) (Wisconsin Family Impact Seminar Briefing Report #15). Madison, WI: University of Wisconsin Center for Excellence in Family Studies.

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