THE FACTORS FUELING RISING HEALTHCARE COSTS

By

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I. Introduction

The following report is a unique attempt to examine rising healthcare costs in the context of the factors that are driving them higher. In the past, most research of rising costs has focused on where the dollar is being spent. This report instead examines why the dollar is being spent. We believe this approach allows the industry to take a deeper look at the issue of rising healthcare costs, and it may give policymakers a better roadmap to use in their efforts to make healthcare more affordable.

Beyond general inflation, other forces are driving recent healthcare cost increases. Our study finds that increased consumer demand, drugs, medical devices, and other medical advances are behind nearly half of the increase. The other half is driven largely by litigation, mandates, and rising provider expenses. For some of the drivers, such as drugs and medical advances, current spending may be offset by future savings in eliminating or reducing other medical services.

A Historical Overview of Rising Costs

For much of the 1990s, healthcare costs rose at a slower rate than had been the case during the previous decade. Health plans were a contributing factor in restraining the growth of healthcare costs. Following a period in the late eighties and early 1990s, in which rising healthcare costs were seemingly out of control, the managed care industry emerged as a dominant leader in the healthcare system.

That costs were held in check during this period is all the more remarkable given the unprecedented strength of the economy. The combination of rapidly growing incomes and labor shortages should have acted as an upward pressure on healthcare prices, due to increased demand and ability to pay. Instead, premium increases fell during the early- to mid-1990s and were at a record low during the period of 1994-1998. In 2000, the share of GDP devoted to healthcare was 13.2 percent (up from 8.8 percent in 1980) and, based on official government forecasts, that share will continue to rise and reach 16 percent of GDP during the next five years.[i]

Consumers pay the greatest price, but rising healthcare costs have an impact on other sectors as well. Employers are increasingly facing difficult choices, as they are forced to pass costs along to their employees, reduce salaries, or reduce benefits. These higher costs constitute a significant upward pressure on other goods and services, and government programs such as Medicare and Medicaid see their funding crises grow worse.

In the following study, we seek to define the extent of the rising cost problem, and attempt to gauge how serious it is likely to become in future years. In this effort, we identify and isolate the specific drivers of rising costs, and we explore each cost driver in depth, looking at the various ways they respectively contribute to the overall cost.

Methodology

For this report, PricewaterhouseCoopers (PwC) has calculated the size of the overall increase between 2001 and 2002 at 13.7 percent. We believe this number represents the average increase in health insurance premiums for large employers. In this report, we will segment the drivers that make up that 13.7 percent.[ii]

While administrative costs are included in health insurance premiums, the lion's share of the increase stems from benefit costs exclusive of administrative expenses. We recognize that benefit costs in this context are not the same as medical costs. As measured by the federal government, overall medical costs are growing at a lower rate of increase. The premiums charged to employers must be a forecast of medical costs for the year ahead, as well as a consideration of costs already incurred. Health insurance actuaries must work backwards when they price future premiums, taking into account past claims experience and factoring in medical cost trends.

II. Major Cost Drivers

Our determination of what trends are driving healthcare premium cost increases is described below. To arrive at the following percentages, we reviewed the literature, published and unpublished, including journal articles and internal memos from health plan actuaries. Internally, we discussed cost trends and their sources with PwC benefit consultants who advise employers and health plans. Externally, we discussed these issues with actuaries and benefit specialists in health plans and company benefits departments.

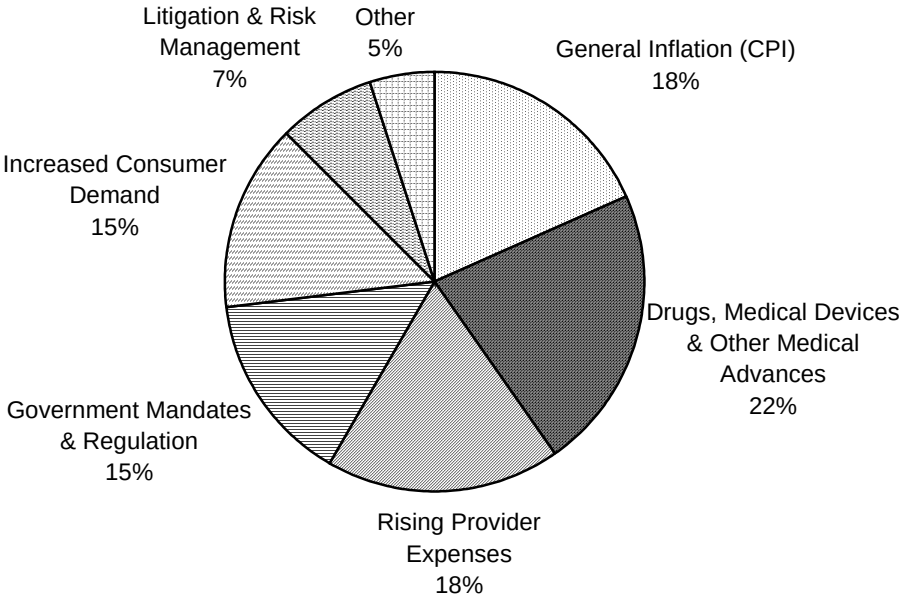
What follows is our best estimate of the various drivers and their contribution to the 13.7 percent trend growth. The relative absolute contribution is shown in Table 1 and the relative shares are shown in Charts 1 and 2.

Table 1
The Factors Driving Rising Costs in Healthcare Premiums (2001-2002)

Trend Factors	Percentage Points	Percent of Total Increase
Medical Trend	**13.7%**	**100%**
General Inflation (CPI)	**2.5%**	**18%**
Drugs, Medical Devices and Medical Advances*	**3.0%**	**22%**
Prescription drugs		
Other advances in diagnostics and treatment		
Rising Provider Expenses	**2.5%**	**18%**
Hospitals (consolidated, in particular) negotiating higher payments		
Government Mandates and Regulation	**2.0%**	**15%**
Over 1,500 existing mandates at state and federal level		
New mandated benefits		
Elimination of cost-control tools or limiting flexibility to use them		
Regulatory requirements (red tape, duplication of federal and state requirements)		
Increased Consumer Demand	**2.0%**	**15%**
Aging population		
"Front page" treatments (i.e., media coverage drives demand for expensive treatment)		
Increased preventive and diagnostic activity		
Consumers moving away from less expensive managed care products		
Litigation and Risk Management	**1.0%**	**7%**
Class action lawsuits		
Outsized awards and legal costs		
Defensive medicine		
Malpractice premiums		
Reinsurance/risk management		
Other Categories	**0.7%**	**5%**
Fraud and Abuse		
Miscellaneous		

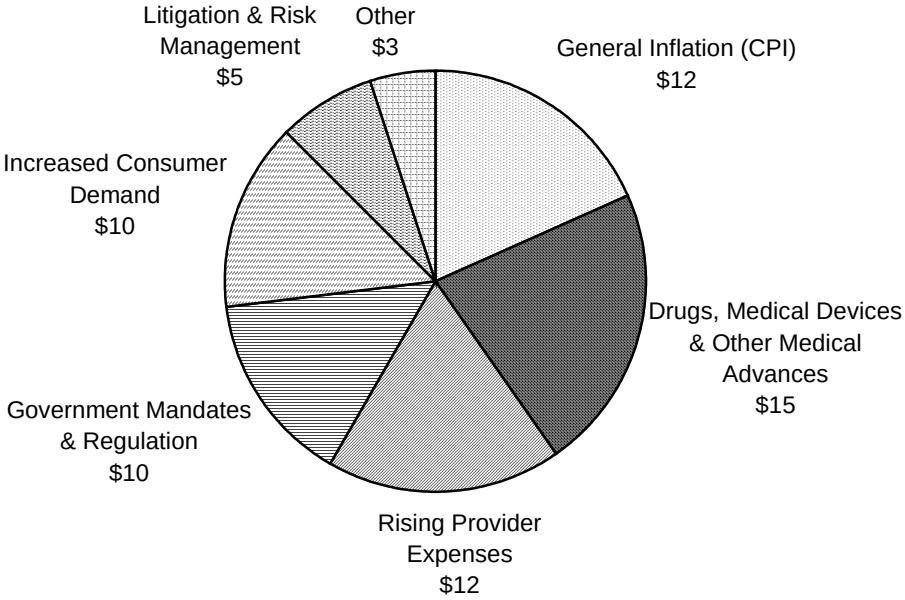
Source: PricewaterhouseCoopers analysis, April 2002.
* This percentage does not reflect potential future savings from drugs, medical devices and other medical advances. For example, savings in future years may include reduced hospitalizations and consumption of other healthcare services.

Chart 1
The Factors Driving Rising Costs in Healthcare (2001-2002)



Source: PricewaterhouseCoopers, April 2002.

Chart 2
The Factors Driving Rising Costs in Healthcare (2001-2002, in $ billions)



Source: PricewaterhouseCoopers, April 2002.

Drugs, Medical Devices and Other Medical Advances

We estimate that medical advances, which includes drugs, devices, treatments, and testing, contributed 3 percent to healthcare costs between 2001 and 2002, or 22 percent of the overall increase as shown in Chart 1. However, this increase does not reflect savings in future years from these advances today. Future-year savings likely include reduced hospitalizations and consumption of other healthcare services.

Medical advances often have inflationary effects. For example, one of the fastest growing areas among hospitals and outpatient centers is radiology. The number of imaging procedures is growing at 8 percent to 9 percent a year, and much of the increase is in more expensive modalities, such as MRI and PET. In addition, some clinicians are combining PET and CT for even more precise diagnoses at ever-higher expense.

It may be that health plans played a positive role in keeping certain medical advances more affordable: for example, spending increases for prescription drugs tempered slightly in 2001 as health plans and employers increasingly moved towards multi-tiered prescription drug formularies. Future forecasts indicate that multi-tiered formularies and other drug benefit management techniques could hold this contribution steady at 3 percent.

However, new laws could result in additional increases in prescription drug costs in the future. Both the Senate-passed and House-passed patients' bill of rights legislation include a provision that could place restrictions on plans' use of multi-tiered formularies –a tool that many plans utilize to limit the out-of-pocket costs of prescription drugs to consumers. If provisions restricting the use of multi-tiered formularies were signed into law, prescription drug costs could rise even more in the future. Some of these increases may be tempered by higher co-pays and deductibles adopted by employers.

Drugs, medical devices, and other medical advances are a significant factor in healthcare premium increases. PwC estimates that this factor added 3 percent to the trend for 2002, or about 22 percent of the overall increase. This represents $15 billion of the increase in health premiums.

Rising Provider Expenses

Rising provider expenses were a factor that precipitated the current trend of rising healthcare costs. PwC estimates that this factor added 2.5 percent to the trend for 2002, or about 18 percent of the overall increase. This represents $12 billion of the increase in health premiums.

Hospital Systems Successfully Negotiating Higher Rates

Record consolidation took place among hospitals during the mid- to late-1990s. As a result, fewer hospital systems dominate many major metropolitan areas. In the past few years, mergers and rising admission levels have shifted negotiating leverage to major hospital systems, which in some markets has resulted in higher hospital rates. In

addition, hospitals' costs, particularly nursing and other personnel costs, have increased faster than revenues. Finally, after under-investing in their physical plants during the mid- to late-1990s, hospitals are once again addressing their physical infrastructures. This has prompted hospitals to ask for larger price increases from payers. As hospitals' negotiating leverage increased, consumers asked their employers to offer insurance products with broader networks of hospitals. To make their products more appealing to consumers, health plans have widened their networks to include more hospitals. However, when plans try to include all providers, costs inevitably increase.

During the height of managed care, providers were willing to share risk with health plans. However, that trend has largely reversed itself. In numerous cases, providers lost money or went bankrupt because they inappropriately allocated the cost of the risk they assumed. Now, most hospitals are refusing risk contracts, instead opting for per-diems or variations of fee-for-service. This shifts most, if not all, of the risk back to health plans or self-insured employers, requiring them to price premiums with the understanding that they're accepting higher levels of risk.

General Inflation

Prices of almost everything inch up over time. The most commonly accepted measure is known as the consumer price index (CPI)—which has been increasing at an annual rate of about 2.5 percent in recent years and accounts for about 18 percent of the overall increase in healthcare costs. Because of this, the measure of spending, the U.S. dollar, becomes worth less each year. Spending on healthcare is expected to increase this much "just to keep up with inflation." Alternatively, we say that healthcare premium costs rose by 11.2 percent in "real" terms (2.5 percent CPI subtracted from 13.7 percent premium increase).

Government Mandates and Regulation

Healthcare is heavily regulated in almost every aspect. Two areas, in particular, appear to be increasing the scope of government regulation and the costs associated with it. First, the spread of state and federal mandates has continued without abatement for the past three decades. Mandates increased 25-fold over the period, 1970-1996, an average annual growth rate of more than 15 percent.[iii] Second, regulations in the healthcare system have increased significantly, and they often duplicate or conflict with rules and regulations at the state level. The Health Insurance Portability and Accountability Act (HIPAA) alone will add billions of dollars in new compliance costs to the healthcare system.

1,500 Mandated Benefits Drive Consumer Costs Higher

Over 1,500 mandated benefits exist at the state and federal level, with many more on the horizon. Each mandate adds its own cost, and collectively they have significantly increased healthcare costs. For instance, research has shown that mandated chemical dependency treatment coverage increased costs by 9 percent in those states that adopted

this type of mandate.[iv] Mandated benefits for routine dental services increased costs by 15 percent. These estimates suggest that mandates have a huge overall impact on healthcare costs. Similarly, a few years ago, the General Accounting Office reported that mandates accounted for up to 22 percent of Maryland's healthcare costs.[v]

In addition to mandated benefit requirements, states have also enacted numerous process and provider mandates. These mandates, which require coverage for specific types of providers and require plans to have specified processes in place, have contributed to the overall cost impact of mandates on health insurance premiums.

New Mandates on the Horizon?

Additionally, both the Senate-passed and House-passed patients' bill of rights legislation include numerous process mandates that would apply simultaneously to state requirements in some instances. Research indicates that this could increase healthcare costs, although studies conflict on whether the increase will be minor or major. One expert's analysis tallied over 700 legal requirements that health plans would be required to follow if a patients' bill of rights were enacted.[vi]

Duplicative and Confusing Regulations Add Billions In Compliance Costs

The second major growth area for government regulation is the Health Insurance Portability and Accountability Act, which requires health plans and providers to institute a variety of new data systems to insure privacy and standardize electronic transactions. The estimated cost of compliance with the HIPAA privacy regulation alone ranges from $3.8 billion (U.S. Department of Health and Human Services) to $43 billion (BlueCross/BlueShield Association).

The contribution of mandates and government regulation is estimated to be about 2 percent, or 15 percent of the overall increase, representing $10 billion of the overall increase in health premiums.

Increased Demand

As Americans age into their 40s, 50s and beyond, they consume more medical resources. The biggest surge of Baby Boomers is currently between the ages of 55 and 59. This group will grow 24 percent between 2001 and 2005 and 41 percent between 2001 and 2010, according to the Census Bureau. On average, a U.S. male's healthcare spending doubles in the 45 to 54 age group, as compared to the 35 to 44 age group. Upon entering the 55 to 64 age group, his spending rises another 50 percent. Baby boomers who used few healthcare services for two decades are turning to physicians, hospitals, and other providers with increasing regularity.

At the same time, consumers are demanding more than ever before from the healthcare system. The Baby Boomers who have driven almost every major trend of the last five decades are very interested in getting the very best medical care no matter how high the costs. Increased advertising for certain brand-name drugs has driven consumers' demand for them. This could impact other areas. Increases in drug spending could pull physician

spending higher as more patients need to see their physicians to access drugs that they see heavily marketed.

Demand for new technologies impacts overall spending as consumers demand that previously uncovered services be paid for by their health insurance. This type of demand leads to government mandates, primarily within the states. One burgeoning area that could increase spending today and could spur demand in the near future is a healthy, asymptomatic individual paying out-of-pocket for whole-body imaging and virtual colonoscopies. Less than 100 whole-body imaging centers are now operating, but that is estimated to soar in the next few years as consumers worry about their chances of cancer and heart attack.

PwC estimates that increased demand is a very powerful force and will continue to be so for the next decade. We estimate that increased demand is adding about 2 percent annually to healthcare costs, or about 15 percent of the overall trend, representing $10 billion of the increased health premiums.

Impact of Litigation

Litigation in the healthcare system has grown dramatically over the past 20 years, resulting in large awards, skyrocketing malpractice insurance premiums, and defensive–but unnecessary–medicine. Meanwhile, a new round of class action lawsuits have targeted major players in the healthcare industry for high-dollar awards, and the legal costs associated with defending even the most frivolous claims have spiraled out of control.

Legal Awards

Damages awarded in malpractice suits are skyrocketing. For example, the median malpractice award increased 43 percent in 2000 to $1 million, according to Jury Verdict Research. A few claims even ran as high as $40 million. Awards are only part of the picture, since the majority of cases never result in a judgment, but cost millions of dollars to defend.

Malpractice Insurance Premiums

In December 2001, St. Paul Companies, one of the nation's largest physician insurers, decided to quit its medical malpractice business nation-wide. As a result, some physicians, medical schools, and hospitals have seen their malpractice premiums increase from 20 percent to 100 percent. Such premiums already run more than $100,000 annually for some specialists, eclipsing what they spend on rent and utilities. The crisis has grown so acute that some states face a severe shortage of key specialties, such as obstetrician-gynecologists, who have been literally unable to afford the price of practicing medicine.

Defensive Medicine

The threat of litigation is a significant driver in the unnecessary use of treatments and medicine, which not only add to the cost of healthcare, but may actually dilute its quality.

Doctors have been outspoken about how the fear of litigation not only causes them to order tests and treatments that are not needed, but also inhibits efforts to report and track incidents relating to medical safety.

Class Action Lawsuits
Over the last few years, health plans have been faced with a growing number of lawsuits brought by physicians and individuals under ERISA, RICO, and state law. Some of these cases include the massive class actions, such as those consolidated in Miami, Florida, which claim to represent all physicians and all health plan subscribers in the United States.

Employer-Based Healthcare
Recent health plan lawsuits have involved claims relating to coverage denials, as well as claims–such as those relating to payment–that traditionally were resolved through negotiations between the parties. Lawsuits against health plans also have involved claims that relate to activities that occur as a matter of course in the managed care business. These claims, if successful, could undermine the very basis of managed care. In many of these cases, numerous parties, including the plan, its administrators and providers, have been named defendants. As with medical malpractice cases, many lack merit, yet resources must still be expended to defend the cases regardless of outcome.

PricewaterhouseCoopers estimates that the cost of litigation and malpractice adds about 1 percent to the cost of healthcare premiums. This makes up 7 percent of the overall increase, representing $5 billion of increased premium costs.

Our forecast is that without significant tort reform this could increase even more in the next few years as consumers become more aware of medical errors and patient safety issues. In addition, as new diagnostic testing, particularly in the area of genetics, becomes more prevalent, the standard of care for early diagnosis of disease will change.

Patients' Bill of Rights
If a federal patients' bill of rights passes that significantly expands health plan liability, healthcare costs could increase even more in the future. As discussed earlier, studies conflict on whether the increase will be minor or major. In an analysis prepared for AAHP, the Barents Group estimated that an expansion of health plan liability similar to that included in the pending patients' bill of rights legislation would result in cost increases of as much as 8.6 percent nationally.[vii] Similarly, according to a fiscal note submitted by the Minnesota Department of Employee Relations, health plan liability requirements would increase premiums by 5 percent.[viii]

Fraud and Abuse and Other Cost Drivers

Large-scale fraud and abuse investigations were launched against nearly every segment of the healthcare industry during the last decade. The absolute level of fraud and abuse may be a significant share of healthcare costs. For example, a 1999 HHS Office of the Inspector General report stated that the annual amount of improper payments due to

coding errors is $2 to $3 billion per year over the last four years. If this level of costs for only a small component in one federal program is typical, the overall impact of fraud and abuse must be large on private health spending as well.

III. Key Findings and Conclusions

In this paper, PricewaterhouseCoopers has quantified the drivers behind the 2002 increase in healthcare premiums. The drivers and their portion of the overall increase are:

- Drugs, medical devices and other medical advances (22 percent)
- Rising provider expenses (18 percent)
- General inflation (18 percent)
- Increased demand (15 percent)
- Government mandates and regulation (15 percent)
- Impact of litigation (7 percent)
- Fraud and abuse and other cost drivers (5 percent)

This report by PricewaterhouseCoopers is unique in that we have attempted to attribute increases in healthcare costs to specific "drivers" that have been defined in new ways. These drivers are the gasoline that fuels new spending on doctors, hospitals, drug companies, and other medical supplies and services. Further, some sectors contend that drivers, such as drugs and medical advances, will reduce future healthcare spending, such as reducing hospital admissions.

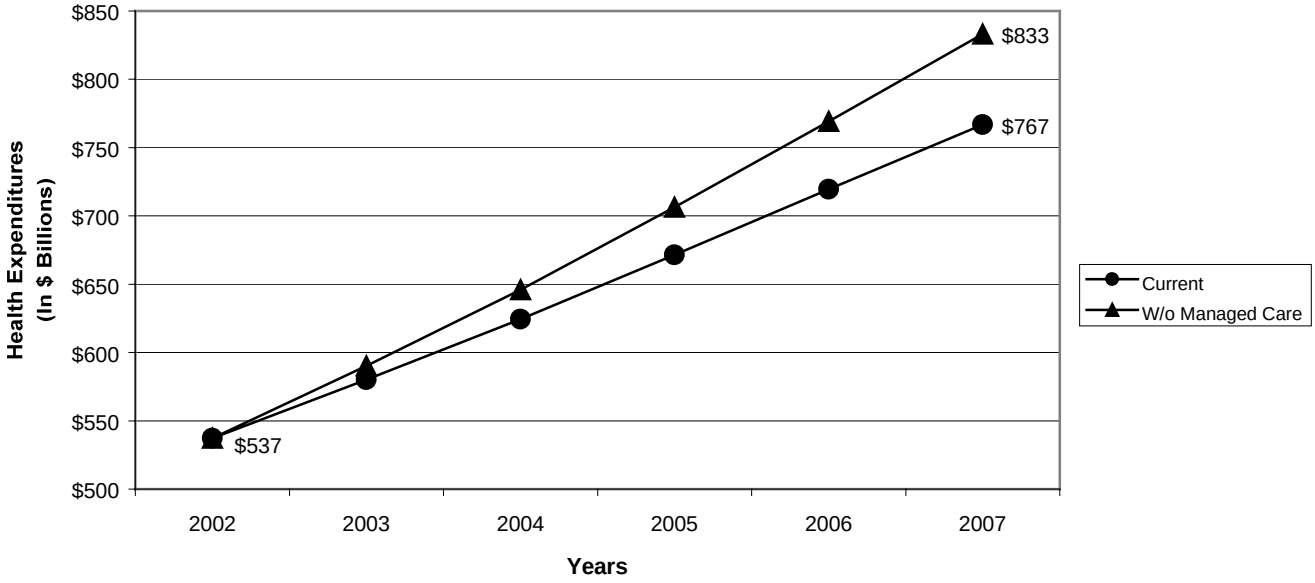
To what degree the major cost drivers in 2002 will influence future cost increases depends on the response to those drivers by payers, providers, patients, and policy makers. However, we believe it is useful to mention that the private health insurance market is moving away from tightly managed health benefit products, and that this, in itself, could inflate premiums with a return to more indemnity-style products.

As discussed previously, the slowdown in rate increases that took place in the early- to mid-1990s is widely thought to have been influenced by the spread of managed care. Likewise, what happens over the next five years will depend to some extent on developments in managed care. For example, Chart 3 below shows that, according to official US government statistics, total spending by private health insurance is expected to increase from $537 billion in 2002 to $767 billion in 2007, an annual growth rate of 7.4 percent.

To show how managed care might affect this growth rate, we adjusted the official forecasts to reflect the rapid disappearance of all but conventional plans between 2002 and 2007. The adjustment was based on data from the Kaiser Family Foundation/HRET Employer Health Benefits 2001 Annual Survey which shows that conventional plans have premiums that are 8.6 percent higher, on average, compared with other plans (HMOs, PPOs, and POSs). Although the data from Kaiser Family Foundation are not adjusted to reflect benefit design and demographics between types of plans, Chart 3 does

illustrate the principle that shifts from lower cost plans to higher cost conventional coverage would increase the trend significantly. Chart 3 shows that without managed care private health insurance is expected to increase from $537 billion in 2002 to $833 billion in 2007, an annual growth rate of 9.2 percent. The difference in spending is $182 billion over the five-year period, or about $1,600 per policyholder over the same five-year period.[ix]

Chart 3
Next Five Years With and Without Managed Care



Source: PricewaterhouseCoopers, April 2002.

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[i] The share could be even higher if the current recession is the beginning of a period of relatively stagnant economic growth. That forecast also assumes that the Congress does not pass any major new programs that reduce the effectiveness of managed care or increase administrative costs to plans and providers.

[ii] This number is based on interviews with PricewaterhouseCoopers consultants as well as discussion with health insurance industry actuaries and a review of reports in the media. Because of the methods used, this estimate is probably more indicative of the increases for large, private-sector employers but the same general forces probably apply to the employees in small firms, public organizations, and to individuals who purchase insurance. If anything, the estimate would be higher for small firms and individual purchasers. It is higher than national averages for cost increases because it reflects private health insurance figures only and does not include data on government programs, which would result in a lower average cost increase. Additionally, it should be noted that government statistics on private health insurance costs suggest that premiums rose about 9 percent in 2000 and are likely to rise about 10 percent in 2001.

[iii] Gail A. Jensen and Michael Morrisey, "Employer-Sponsored Health Insurance and Mandated Benefit Laws," The Milbank Quarterly, Vol. 77, No. 4, 1999.

[iv] Ibid.

[v] GAO, Health Insurance Regulation: Varying State Requirements Affect Cost of Insurance, August 1996.

[vi] William G. Schiffbauer, Beyond the Sound Bite: Implementing the Patients' Bill of Rights, BNA, February 27, 2002.

[vii] Barents Group, Impacts of Four Legislative Provisions on Managed Care Consumers, 1999-2003, April 22, 1998.

[viii] MN Department of Employee Relations, "Revised Fiscal Note for S.B. 953," April 1999.

[ix] This calculation is computed by dividing the estimated $182 billion in savings by the average number of policyholders between 2002 and 2007. The number of policyholders is estimated to be an average of 113 million during that period. Policyholders are usually families, but they also may be single workers or individuals who have purchased a health plan.