

Health care's perfect storm

Several factors converge to create double-digit health care costs

BY TRUDI MATTHEWS

The best-selling book and popular movie, *The Perfect Storm*, chronicles the development of one of the worst Nor'easter storms in recorded history. This singular storm that hit in October 1991 was the result of three major storm systems converging at the same time and place in a way that defied the laws of probability.

Some health care analysts have described the state of the health care marketplace as its own "perfect storm." To many, it seems that the factors driving health care costs have all converged simultaneously to create a tempest that combines the destructive forces of double-digit health care inflation with limited state, federal and private resources, leaving policymakers with no quick or easy solutions for riding out the storm.

Gauging the storm's severity

Several recently released reports paint a grim picture of health care cost growth. Health care spending in 2001 grew nationally by 10 percent, moving into the double digits for the first time in more than a decade, according to a study by Bradley Strunk, Paul Ginsburg and Jon Gabel published in the September issue of the journal *Health Affairs*. This is the fifth straight year of growth at a rate higher than the previous year.

The picture is worse still when looking at employer-sponsored health insurance premiums. Health insurance premium

increases averaged 12.7 percent in 2001, according to a report by the Kaiser Family Foundation and the Health Research and Educational Trust. A Mercer Human Resources Consulting survey of employers found that health care costs per employee increased 14.7 percent in 2002.

These figures were after employers took cost-cutting measures, such as scaling back benefits and increasing employee cost sharing. Actual premium growth would have been much higher if employers had stuck to the same health plan benefits as in previous years. "Overall the level of costs are unacceptably high in all markets but especially in the small group market," said Janie Miller, secretary of Kentucky's Department of Insurance. "Compounded by the economy and investment markets, employers just can't absorb these increases."

State governments are feeling the impact of health care spending growth on several levels. Increased health care costs in state Medicaid programs are decimating state budgets because Medicaid represents approximately 20 percent of the average state budget. Since state government is also the largest employer in most states, rising health insurance premiums means that employee benefits are becoming more expensive, cutting further into state budgets.

In addition, states must also worry about the stability of their private insurance market. As employers and employees feel the

pinch from rising health care costs, states may experience a decrease in employers offering health care benefits as well as a drop in the number of people enrolling in employer-sponsored insurance. This could result in increases in public health care enrollment, the number of uninsured and the amount of uncompensated care for health care providers.

Although analysts believe that health care costs reached their peak in 2001, those costs are still expected to grow faster than the economy for many years. Owing to American's love of new medical technology, an aging population, higher medical malpractice premiums and the retreat from managed care, there is no end in sight for the current wave of health care inflation.

Even if the economic picture improves dramatically in the coming months, state revenues may not improve immediately. "There is a lag between the national economic picture and state revenues of about 12 to 18 months," said Len Nichols, vice president of the Center for Studying Health Systems Change speaking at a recent CSG meeting. "So policymakers can expect that 2003 will be worse than 2002."

Explaining health care cost growth

A number of factors have come together to create the current gloomy outlook in health care. The fastest growing portion of the health care pie is now hospital out-

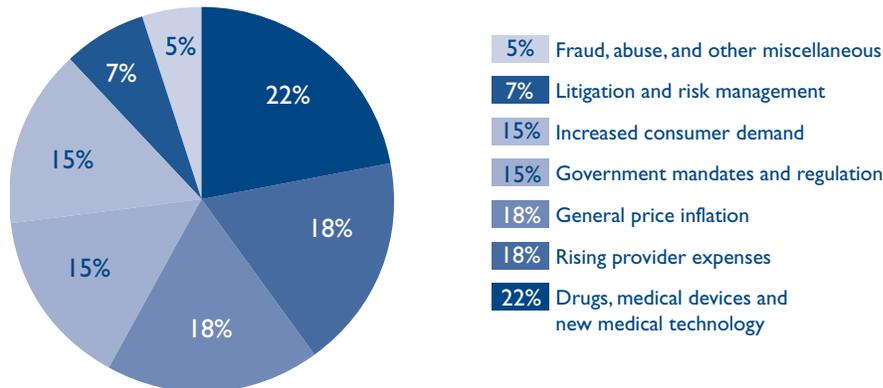
patient costs, which grew by 16.3 percent in 2001, according to the research performed by Strunk, Ginsburg and Gabel. In second place is prescription drug spending at 13.8 percent, followed by hospital inpatient costs at 7.1 percent and physician costs at 6.7 percent.

Hospital costs overall have become the leading driver of health care costs in the United States, with increases in inpatient and outpatient costs accounting for more than 50 percent of the increase in national health care expenditures in 2001. Although prescription drug prices receive much media attention, the growth in hospital spending is more significant than the rise in prescription drug prices because hospital costs make up about one-third of all health care spending. Prescription drugs represent about 10 percent.

Underlying the growth in hospital costs are increases in use of services and the higher prices for those services.

With the retreat from tightly controlled managed care, patients and providers now face fewer restraints on their use of health care services. All over the country, emergency rooms are overcrowded, patients are diverted, patient care is delayed, physicians are working longer hours, and there are shortages of nurses and staffed hospital beds. All those factors are evidence of a

An April 2002 PricewaterhouseCoopers analysis broke down the contributing factors to growth in health care costs accordingly:



health care system operating with little excess capacity, Nichols said. Thus, increased demand and constrained supplies are driving costs up.

Hospitals and other providers are also taking tougher stances in negotiations with health plans and demanding higher reimbursement rates. Cuts in Medicare reimbursement rates under the Balanced Budget Act of 1997 have resulted in providers making up this lost revenue from other sources. "The pendulum has swung in the other direction. Over the last three to four years, hospital consolidation and

decreases in the number of hospital beds has made it less important for hospitals to compete for market share," said Lew Devendorf, practice leader for Mercer Human Resources Consulting's South Unit. "There is a less competitive marketplace among hospitals."

Another big contributor to rising health care costs is prescription drug costs, which have risen by double digits each year since 1995. Most of the increase in spending for prescription drugs can be attributed to increased use of drugs over other interventions and the use of newer, higher cost drugs rather than older, cheaper therapies.

Cost increases for prescription drugs, however, have slowed in the past few years. In 2001, more than half of large employers had instituted tiered co-payments, according to the Mercer survey. "Tiered co-payments for prescription drugs are helping to control the growth in drug spending," said Devendorf.

Health care costs force decisions

Medicaid spending grew by 12.8 percent in 2002, according to figures from the Kaiser Commission on Medicaid and the Uninsured. Costs are expected to increase by 9 percent next year, according to Len Nichols of the Center for Studying Health Systems Change. This tremendous growth has placed enormous pressure on stagnant state budgets and forced some hard choices.

Because of Medicaid's unique structure and enrollment, the sources of cost growth differ slightly from the national picture and from the private insurance market. Of the \$15.7 billion increase in federal Medicaid expenditures in 2001-2002, \$9 billion – nearly

60 percent – came from elderly and disabled enrollees, according to the Kaiser Commission. This is true even though elderly and disabled enrollees make up less than a third of most states' Medicaid enrollment.

States used a number of different strategies to control costs in 2002. Thirty-two states increased restrictions on prescription drugs, 22 states cut provider payments, nine states reduced benefits, eight states reduced eligibility, and four increased enrollee co-payments, according to the Kaiser Commission. These efforts will likely be expanded in 2003 as states continue to experience revenue shortfalls and higher Medicaid growth rates.

Insight into health insurance premium hikes

In the past few years, health insurance premiums have also risen dramatically, outpacing actual health care costs by several percentage points.

Although underlying health care costs explain much of the increase in health insurance premiums, the insurance actuarial cycle and market changes also have affected premium growth. For much of the 1990s, insurers kept premium increases

National summit on chronic illness in April

An estimated 125 million Americans – almost half the population – are estimated to have at least one chronic illness that requires ongoing treatment over many months or years. Chronic illnesses are the leading causes of death and disability in the United States. They are responsible for about 75 percent of the nation's health care expenditures. Recognizing the role that chronic illness plays in health care costs, states and private sector companies are experiment-

ing with disease management, case management and other programs that may improve the quality of care and control costs for chronic illness.

In an effort to assist states leaders, CSG plans to hold a national summit in Washington D.C. April 11-13 and produce a *State Official's Guide On Chronic Illness and Disease Management*. Gov. Mike Huckabee of Arkansas, CSG's president, said spotlighting chronic illness will be among his and CSG's top

initiatives in 2003.

CSG has received support for the project from the Agency for Healthcare Research and Quality, the Robert Wood Johnson Foundation, Pfizer, the American Heart Association, Schering-Plough and the National Pharmaceutical Council.

For more information on CSG's chronic illness initiative, contact Trudi Matthews at (859) 244-8157 or tmatthews@csq.org.

low in order to gain market share and offset their revenues with investment income, according to Strunk, Ginsburg and Gabel. Since the Sept. 11th attacks and the beginning of the recession, insurers have focused on shoring up their financial health. With revenues from the stock market down, they have passed increasing costs on to employers and employees.

Strategies for weathering the storm

As health care costs have risen dramatically, different strategies for cost containment have emerged. Overall, the new word in cost containment is greater consumer involvement so that patients are aware of their medical costs. "We have separated the decision-maker in health care from the consequences of cost," said Miller. "We need to educate consumers and reconnect decisions to use health care with the cost of care."

In the employer-sponsored insurance market, rather than trying to place limits on access to certain services and moving

toward more tightly managed care, employers are increasing co-payments, deductibles and premiums and scaling back some benefits to control costs. "The bottom line is that employers have to shift more of the responsibility to employees," said Devendorf.

Insurers and employers also are increasingly using innovative benefit designs and cost-sharing strategies to control costs. Three- and four-tier drug co-payments for generic, preferred brand, and non-preferred drugs have become commonplace.

Some employers and insurers are also moving to tiered payments for providers. Rather than use referrals to control access to specialists, plans have enrollees pay a higher co-payment for using a specialist's care.

In addition, new types of consumer-driven health plans, called by various names such as defined contribution plans, personal care account plans, or health care savings accounts, are springing up all over the country. Typically, these health plans involve the employer placing

a defined amount of money into an account for an employee to use to purchase health care services. Once the employer allotment is used, the employee is responsible for the costs of care up to a certain amount, usually in the range of \$1,000 to \$2,500. Beyond that amount, catastrophic insurance coverage kicks in to cover any remaining amounts over the employer's contribution and the employee's deductible.

The advantage of consumer-directed plans is that they encourage enrollees to be more cost-conscious and aware of their medical spending. These plans also help keep health care costs lower and keep relatively healthy people enrolled in insurance programs. Detractors argue that they place enrollees at too great a financial risk and may cause healthier employees to leave traditional plans, thus undercutting one of the main goals of insurance – managing risk across a diverse group of individuals.

Despite the debate about consumer-driven health plans, employers see this new product as an important tool in the

Resources on health care crisis

The article by Strunk, Ginsburg, and Gabel, "Tracking Health Care Costs: Growth Accelerates Again in 2001," *Health Affairs*, September 25, 2002, is available on the Web at http://www.healthaffairs.org/WebExclusives/Strunk_Web_Excl_092502.htm. Findings from Strunk, Ginsburg and Gabel are also available on the Web through the Center for Studying Health Systems Change at <http://www.hschange.com/content/472>.

The Kaiser Family Foundation-Health Research and Educational Trust's 2002 Employer Health Benefits survey is available on the Web at <http://www.kff.org/content/2002/20020905a/3252a.pdf>.

Information on Mercer's 2002 US Health Care Survey results is available on the Web at <http://www.mercerhr.com/pressrelease/details.jhtml?idContent=1076975>.

cost-containment arsenal. "We project that enrollment in personal care account plans will double every six months over the next few years," said Barbara Alvey, a principal in Mercer's Louisville office. "By the first quarter of 2003, 100 to 150 large employers will offer these types of plans."

Disease management and intensive case management programs that are directed to high cost enrollees are examples of the new focus on consumerism. The prevailing wisdom is that the 20 percent of enrollees with high cost, chronic health care conditions are responsible for 80 percent of costs. If health plans can help chronically ill patients manage their illnesses better over time, costs will be lower over time.

Another strategy gaining wider acceptance is the use of health maintenance and wellness programs. There is a need to change the culture of health care in this country and look at personal responsibility and the escalation of preventable chronic illness, according to Nichols. Purchasers of all kinds – employers, state and federal governments – recognize that in the long-term a healthier employee population means lower costs. "We need to emphasize healthy lifestyles," said Miller. "Kentucky has made major gains, but we have a long way to go."

Emphasis on quality-of-care initiatives is also gaining momentum. Research has documented extensive variations in quality among health care providers. Having patients use health care providers that deliver the highest quality care will save money in the long term. "We have to tell some providers no," said Nichols. "Some hospitals and doctors are not the best at

Percent change per capita in health care spending, 1991-2002						
Year	All Services	Hospital Inpatient	Hospital Outpatient	Physician Services	Prescript. Drugs	GDP Growth
1991	6.9	3.5	16.8	5.4	12.4	1.8
1992	6.6	2.8	13.9	5.9	11.7	4.2
1993	5.0	4.8	8.9	3.3	7.1	3.8
1994	2.1	-2.0	8.7	1.7	5.2	4.9
1995	2.2	-3.5	7.9	1.9	10.6	3.7
1996	2.0	-4.4	7.7	1.6	11.0	4.4
1997	3.3	-5.3	9.5	3.4	11.5	5.2
1998	5.3	-0.2	7.5	4.7	14.1	4.3
1999	7.1	1.6	10.2	5.0	18.4	4.4
2000	7.8	2.5	11.5	6.3	14.5	4.7
2001	10.0	7.1	16.3	6.7	13.8	1.4
2002*	8.8	6.2	13.6	5.7	13.0	1.8

Source: Strunk, Ginsburg, and Gabel, *Health Affairs*, September 2002, www.healthaffairs.org; * = projected

providing certain services."

Used effectively by coalitions of employers around the country, quality initiatives try to ensure that employers get the most bang for their buck through the use of evidence-based medicine, centers of excellence, patient-safety initiatives and incentives to improve quality. "We know that there is a two- to five-time deviation in the efficiency of physician practices after leveling the field for quality," said Devendorf. "With the right kind of data analysis, employers can use tiered networks to encourage employees to use the most efficient, highest quality providers."

State responses

As states attempt to deal with the effects of this new wave of health care cost growth, a number of issues have emerged.

State leaders are looking at the competitiveness of their insurance markets. Evidence of this is increased scrutiny of insurance mandates. Throughout the 1990s states passed laws mandating insurers cover various types of services. During a time of low medical inflation, slightly higher premiums seemed a small tradeoff for protecting patients. There are now 16 states with laws that require review of insurance mandates for benefits and costs, 11 of them passed only in the last two years, according to *American Medical News*.

Other widely accepted patient protection measures are also being reexamined, such as any-willing-provider laws, which require health plans to contract with any provider willing to accept their fees and contractual requirements. Some states' any-willing-provider laws make it difficult for health plans to create tiered networks based on health care quality, Alvey said.

If the rising tide of health care inflation seems overwhelming to states now, analysts argue that the storm on the horizon will be much worse. "Fifty percent of the working population is baby boomers. The aging of America and the sheer number of baby boomers will contribute heavily to health care cost growth in the future," Devendorf said. "We have a category five hurricane waiting in the wings."



— Trudi Matthews is The Council of State Governments' chief health policy analyst.

