COST CONTAINMENT

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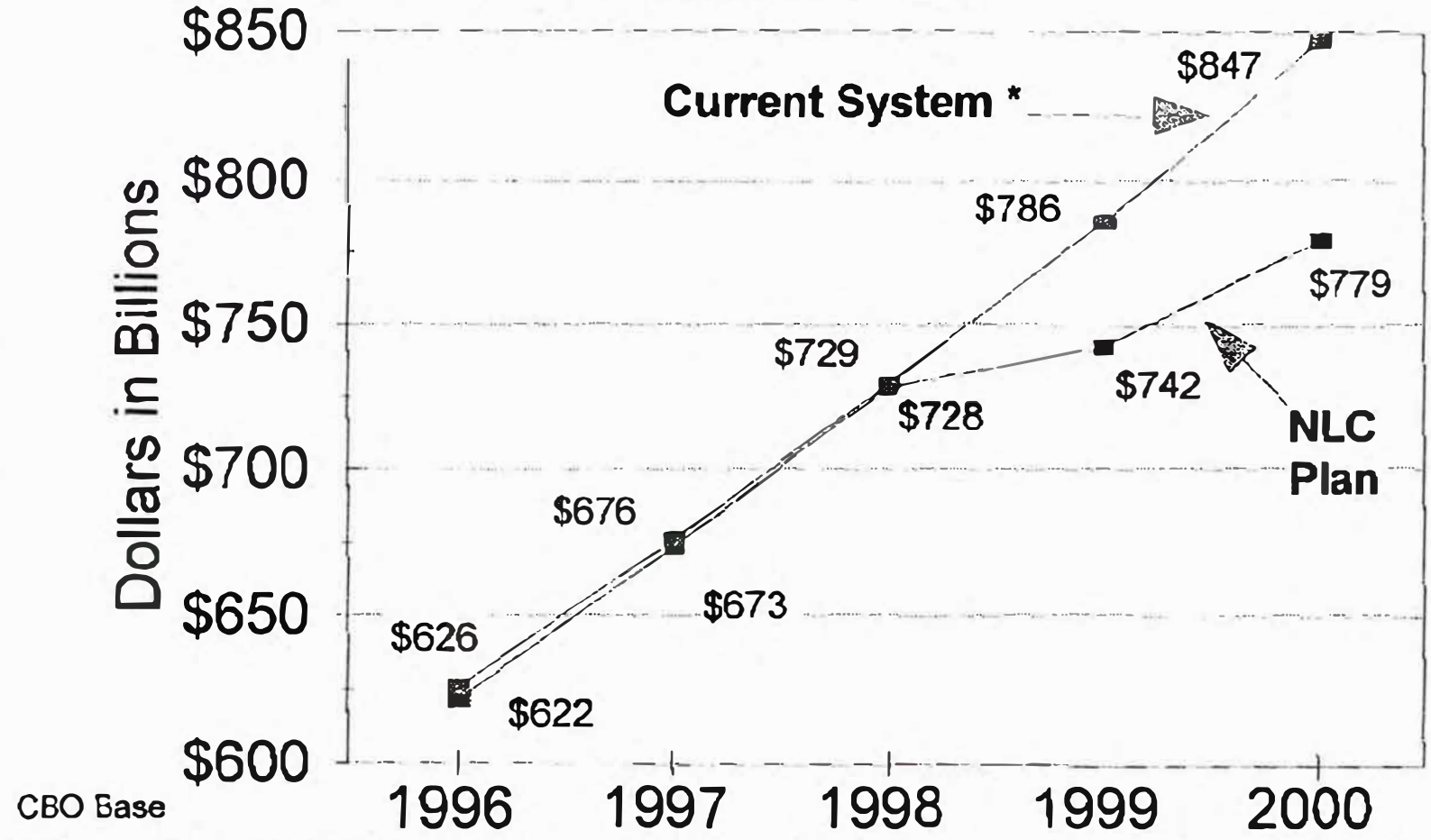
# Private Sector Health Care Spending

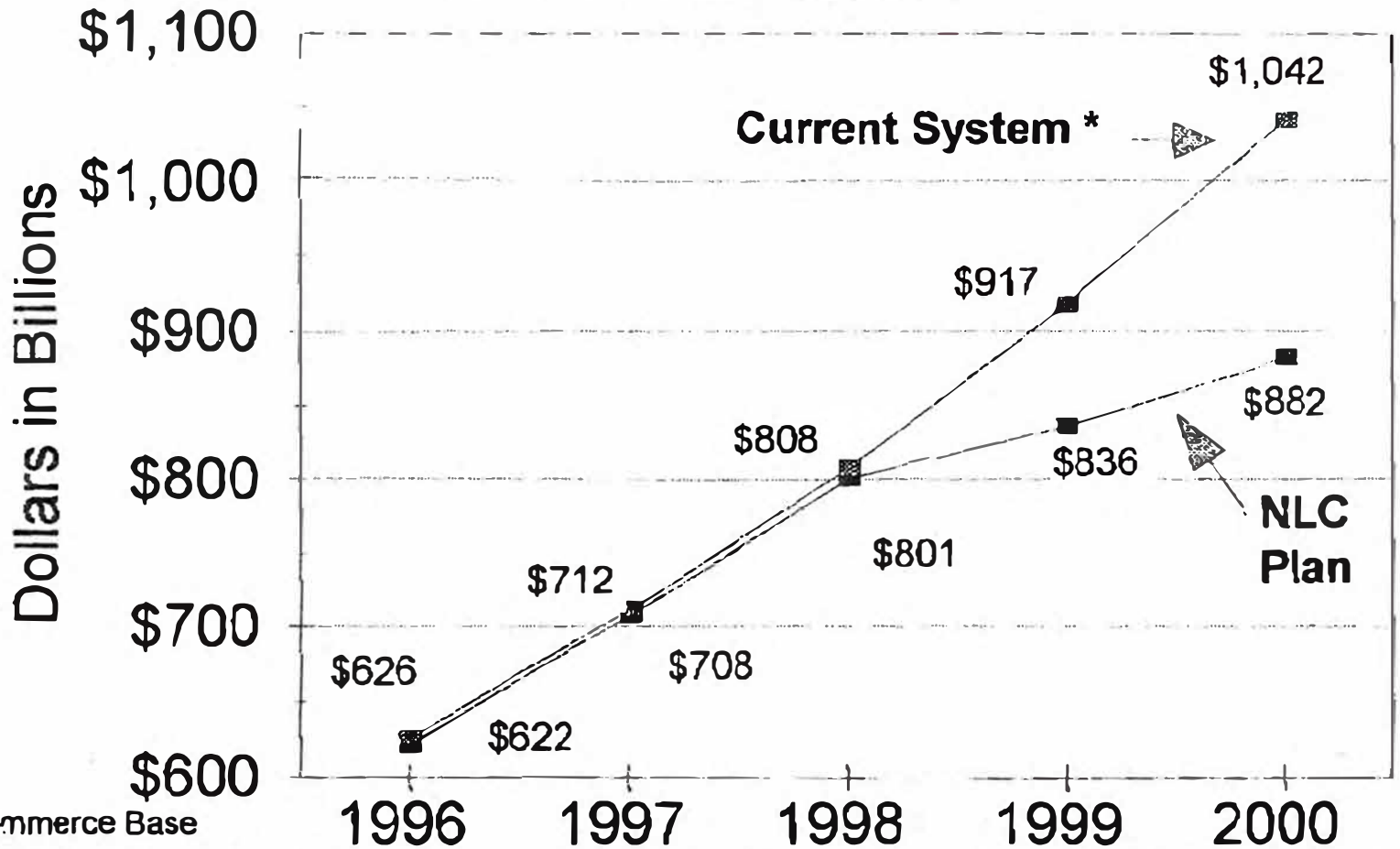
## With and Without Private Sector Cost Containment




* With scheduled public sector savings and without private sector cost containment.

# Private Sector Health Care Spending

## With and Without Private Sector Cost Containment




* With scheduled public sector savings and without private sector cost containment.

Research Agenda Brief

May 1994

# Is the Health Care Cost Crisis Over?

# A Review of Recent Evidence on Health Care Prices, Expenditures, and Insurance Premiums

*Based on a National Health Policy Forum discussion by a panel, including:*

John Cookson, FSA, MAAA
Milliman & Robertson

Jon Gabel
Group Health Association of America

Stuart Guterman
Prospective Payment Assessment Commission

Prepared by *Lynn Etheredge, Consultant.* Sponsored as an activity of the George Washington University project on health reform, with funding from the Robert Wood Johnson Foundation.

## EXECUTIVE SUMMARY

During the past several months, there have been reports about favorable trends in health care prices, expenditures, and insurance premiums. Some observers have suggested that these figures show that the health cost crisis is being solved by the private sector without government reforms. Others have been skeptical about attributing much significance to recent trends and have recalled the health industry's (short-lived) "voluntary effort" slowdown to stave off national health cost legislation in the 1980s.

The discussions and data reported in this paper suggest three major conclusions. These views are not necessarily endorsed by each participant.

- Major data sources all indicate a recent slowing of medical care inflation, particularly in 1993.
- Medical care inflation could be described, however, as either unusually low or high, depending on the measure used. The reported 1993 increase in the medical care CPI, 5.9%, was the lowest in 20 years. Adjusting this report for underlying inflation, however, shows a *real* rate of medical price inflation in 1993, 2.9%, that was still 0.8% higher than the norm for the 1967-1993 period.
- The many changes in how hospitals, physicians, and health plans are buying and selling services make it increasingly difficult to track and assess what is occurring from available data sources. The most timely, the CPI, is an increasingly questionable indicator of actual payment rates and does not measure service volume changes. Insurance premium trends are difficult to interpret due to the insurance underwriting cycle and insurer pricing practices, as well as benefit changes. Other data sources also have serious problems of scope, timeliness and interpretation.

On the critical issue of whether a large and permanent change in the rate of health care cost increases can be inferred from the available data, most discussants were doubtful.

## INTRODUCTION

To explore recent trends in health care prices, expenditures, and insurance premiums, the National Health Policy Forum, in collaboration with the George Washington University Project on Health Insurance Reform, convened a meeting that brought together three experts who have recently authored analyses of these trend data for a discussion with senior professional staff from the legislative and executive branches, including DHHS' Health Care Financing Administration (Office of the Actuary) and the Congressional Budget Office. The meeting was held on February 18, 1994.

The three experts and their areas of discussion were:

- John Cookson, editor of Milliman & Robertson's *Health Cost Index Report* who discussed relevance of the CPI index and national tracking data for health insurance costs and premiums, including regional variations;
- John Gabel, director of employee benefits research for KPMG Peat Marwick, who described his recent studies and reports on multi-year trends in health insurance premiums and benefits; and
- Stuart Guterman from PROPAC, who presented its analyses of hospital sector trends largely based on American Hospital Association tracking studies.

For the panelists and NHPF attendees, Lynn Etheredge prepared a summary and analysis of the relevant statistical data. That background paper is included as an attachment to this report.

## THE CONSUMER PRICE INDEX (CPI) AND OTHER PRICE MEASURES

The Consumer Price Index (CPI) for medical care and its component indices—such as prescription drugs, physicians services, and hospital services—are the federal government's only monthly tracking indicators for health care inflation. These statistics are widely reported and their recent trends have received much media attention.

The Forum discussions focused on two issues:

- How accurately do the price series data track prices actually paid for health care services?
- To what extent do the data series support the proposition that health care inflation, compared to past rates of increase, has slowed markedly?

### Limitations of the CPI

The medical care CPI index is often cited as an indicator of overall medical care inflation. But experts and commentators noted that it is not designed for this purpose and has systematic inaccuracies as an overall inflation measure.

Specifically, these limitations fall into two categories:

***Weighting of Component Prices.*** The CPI is intended to measure prices paid by *consumers*. In most markets, consumers do pay the supplier's charges themselves out-of-pocket. In health care, however, the prevalence of *insurance payment* means that consumers often pay only a fraction of the provider's full charge.

The CPI index is constructed by taking data on individual prices and then weighting them by the consumer out-of-pocket spending for that service in proportion to all consumer out-of-pocket spending for medical care. Thus, relative to national health care spending, the medical care CPI under-weights inflation in hospital care and physician services, for example, since these are two types of care where third-party payment finances 97% and 82% of the bill respectively. Overall, third-party payments financed 78% of all personal health care expenses in 1991. Since highly insured services have tended to have higher rates of price increase than less-insured services, the medical care CPI tends to be a significant *underestimate* for trends in both overall medical care inflation and in prices for the services that are paid by a typical health insurance policy.

How large are these differences? According to John Cookson's estimates, which reweight the medical care CPI components for their role in health insurance premium costs, one would need to add about .75% to the reported medical CPI to obtain an accurate estimate for its impact on indemnity health insurance claims costs.

***Reported Prices versus Prices Paid.*** The second source of inaccuracy in the medical care CPI and its components as a measure of price inflation is that the "list" prices it reports probably increasingly misrepresent the amounts actually being paid for a service. This problem has grown as public programs (e.g., Medicare and Medicaid) and private insurance (HMOs, PPOs, and other forms of managed care) have moved away from traditional insurance reimbursements of the amounts charged by providers toward prospectively set fee schedules and negotiated fees for individual payers. Discussions at the meeting elicited estimates that many insurers are able to obtain hospital discounts of 25% to 30% from listed charges, and that only about 20% of hospital payments are now at the listed prices.

The data for trying to sort out what is going on in private sector payment trends still leave much to be desired, but discussants offered three items of information:

- For hospital services, the slowdown of hospital price increases was probably influenced by an infusion of some $15 billion in disproportionate share payments for 1990-1993, which reduced the need for hospitals to raise prices.
- For hospital services, the AHA's hospital panel survey data, as analyzed by the Prospective Payment Assessment Commission (PROPAC) at the meeting, show that, in *real* terms, hospital costs per admission were running about 2.5% annually in 1993, compared to the 5.5% real rate of increase in the CPI hospital services index. The employment cost index for hospital workers rose less than that for non-hospital workers in 1993. These measures suggest there has been a significant slowing in factors underlying hospital inflation.
- For physicians' services, the Physician Payment Review Commission (PPRC) recently completed a report that estimates, based on several large private insurance data bases, that median prices paid by private insurance for physicians services grew about 3.4% per year from 1989 to 1993, compared to the 6.3% rise in the CPI physician services index for the same period.[1]

These PROPAC and PPRC indicators are consistent with a hypothesis that inflation in actual medical care payment rates may be slower than reported by the CPI "list" prices.

**Nominal versus Real Rates of Price Increase**

The interpretation of the CPI and other price trends can vary depending on whether one is focusing on the actual reported index (the "nominal" increases) or the index as adjusted for the overall rate of inflation (the "real" increase). As discussed in the background paper, by both measures, medical care inflation has slowed significantly. In 1993, the medical care CPI and its prescription drug and physicians' services components were at or near record low rates of increase for the past 20 years. Nevertheless, a good portion of this improvement can be attributed to the fact that the underlying rate of price inflation in the economy was also quite low. In real terms, the medical care CPI and its hospital, physician, and prescription drug components were still increasing about 0.5% to 0.8% *faster* than their historic averages in 1993. As discussed in the meeting, medical care inflation in 1993 could be described as either unusually low or high depending upon which measure is used.

**INSURANCE PREMIUMS**

After a discussion of medical care price inflation measures, the meeting turned to a discussion of recent trends in the health insurance market. The movement to "managed care" is hoped by many to have the potential for major benefits in slowing health care inflation. As reported in KPMG surveys, managed care plans grew from 29% to 51% of employees over the 1988-1993 period. Since so much of health care costs are paid by health insurance, the trends in health insurance premiums are an important measure of inflationary cost increases for employers and individuals.

As with the previous discussion on prices, the favorable trends in health insurance premiums reported in the background paper and studies were illuminated by expert commentary on several points, including:

- the difficulty of comparing trends in reported premiums by managed care and traditional insurance plans,

[1]Physician Payment Review Commission *Annual Report to Congress* 1994, chapter 19, p. 380.

- the difficulty of comparing health insurance premiums over time in light of benefit changes, and
- the difficulty of sorting out short-term pricing tactics and the "insurance cycle" from fundamental changes in cost-control effectiveness.

**Premium Differences among Types of Plans**

The reported lower rates of inflation in premiums for managed care (HMOs, PPOs) compared to fee-for-service (FFS) plans is probably partly due to selection effects. To the extent it is healthier people who move from traditional to managed care plans, the average expense of the remaining enrollees in the FFS plans will rise, simply because they are in a less healthy group than in the previous year. Thus, the premium increase differences among types of plans should not be considered a definitive indicator of their competence to manage costs.

**Changes in Benefits**

Changes in benefits also complicate the comparison of premium increases. As shown in the KPMG study, for example, FFS and PPO plan deductibles were increased at more than double the inflation rate over the 1988-1993 period. Some of the premium slowdown is thus attributable to benefit cutbacks.

**Short-Term Pricing Behavior and the "Insurance Cycle"**

Finally, the discussants pointed out that much of the recent slowdown in health insurance premium increases—John Cookson's tracking data show the trends falling below 6% toward the end of 1993, although with wide regional differences—cannot be attributed to effective purchasing alone. As insurance experts noted, the insurance industry historically goes through three-year cycles of premium increases that exceed underlying cost increases (and build up reserves), followed by three-year cycles of premium increases that underprice for underlying cost increases (and deplete reserves). The health insurance industry ended an extended four- year up-phase of the insurance cycle in 1992. Following its historical pattern, the insurance industry would be expected to be aggressively bidding premiums for 1993 and 1994. Were this historical pattern to continue, experts would expect to see much higher rates of premium increases as health insurance reform legislation was being implemented.

**Health Insurance Premiums and Affordability**

As reported in the KPMG study, health insurance premium increases in 1993 ranged from 7.2% to 9.1%, depending on type of plan. Even though this was a substantial slowing over the 1989-1993 period, these rates of increase were still significantly faster than the overall increase in wages and salaries, which was 3.1% in 1993.[2]

## CONCLUSIONS

At the risk of oversimplifying a productive and sophisticated discussion, several conclusions can be supported about the available data, as assessed by the attendees at the meeting.

- The recent overall trends in health care prices, costs, and insurance premiums all indicate significant slowing in rates of increase, but the data are not good enough for definitive analyses. Aggregate data do not establish specific causes of the trends, nor do they speak to regional variations.
- Just how favorable these trends are is subject to a significant range of inter-

[2]Council of Economic Advisers *Economic Report of the President* 1994, p. 321.

pretation and depends on the measure chosen—and on the payer as well. Optimists can cite the nominal increase in the medical care CPI and other indicators showing near-record low inflation compared to the last 20 years. Pessimists can cite the real rates of increase in the medical care CPI showing higher-than-average inflation compared to the last 20 years. It is important not to focus on any one measure.

- It is not possible to have much certainty concerning what recent trends portend for future developments in health care prices, costs, and health insurance trends, with or without health care reform legislation. Optimists can cite the rapid growth of the managed care industry. Pessimists can cite the history of the health sector's previous voluntary effort and the insurance underwriting cycle that suggest renewal of high inflation rates after legislative action on health care reform.

## THE NEED FOR BETTER DATA AND SPECIFIC STUDIES

The meeting highlighted the problems of inadequate national data for tracking national trends in health care prices, costs and premiums, and the dearth of studies about the emerging "managed care" industry. The most timely piece of data, the CPI, has limited validity; the most valid data, the national health spending reports, lag several years.

Some of the data needs and studies that would be most useful are:

- Since the federal government's CPI measures are apparently increasingly inaccurate as indicators of changes in prices being paid for services—and it has even less accurate and timely measures for other health sector trends—consideration should be given to instituting new, timely tracking systems for national trends in actual prices, spending, and health insurance premiums. A followup paper or discussion on design of such data systems may be useful.
- On a short-term basis, the AMA and AHA conduct periodic surveys of hospitals and physicians. It may be possible for such surveys to gather information on the extent to which reimbursement is now by negotiated or regulated fees, and how average reimbursements under such arrangements compare to "list" (CPI-reported) prices.
- Many questions about recent trends cannot be resolved by the available indicators; they must await, at least, the publication of updated national health care spending accounts. The last published national health expenditure data are for 1991; more timely development of such data would be desirable.

**Appendix A:**

## IS THE HEALTH CARE COST CRISIS OVER? A REVIEW OF RECENT EVIDENCE ON HEALTH CARE PRICES, EXPENDITURES, AND INSURANCE PREMIUMS

*Lynn Etheredge*

The purpose of this paper is to summarize recent reports about health care prices, expenditures, and insurance premiums for an expert meeting hosted by the National Health Policy Forum and the Health Insurance Reform Project, both affiliated with George Washington University.

### DATA SOURCES

The major data sources reviewed are:

- *the consumer price index (CPI) and its component elements*, including monthly tracking of overall medical care pricing, physicians' services, prescription drugs, and hospital and related services;
- *AHA hospital panel survey data* that track hospital revenues and costs on a quarterly basis;
- *health insurance premium trends* as analyzed by a recent national survey conducted by Jon Gabel (KPMG Peat Marwick) and quarterly tracking reports by John Cookson (Milliman & Robertson); and
- *national expenditure estimates* as updated by the Congressional Budget Office for recent trends.

### CONSUMER PRICE INDEX (BLS)

The first eight charts show trends in the medical care consumer price index and three of its components (prescription drugs, physicians' services, and hospital and related services). The major trends, calculated as increases in the indexes' annual averages, are:

- *The overall medical care index* rose 5.9% in 1993 (Chart 1). This index has been slowing now for three years since 1990 (9.0%): 1991 (8.7%), 1992 (7.4%), 1993 (5.9%). The 1993 medical care inflation rate was the lowest in 20 years, since the 1972-73 government price control years. Nevertheless, this analysis needs to be supplemented by a comparison of medical care prices to the overall consumer price index. This is particularly important because the CPI growth rate also slowed over the 1990-93 period On this basis (Chart 2), there has been a two-year decline for 1992 and 1993; medical inflation in 1993 (5.9%) was 2.9% over the 3.0% rise in the consumer price index. The chart also shows that the year-to-year relationship of medical care prices and the CPI fluctuates; medical prices grew significantly slower than the CPI, for example, during the price control period (1971-74) and the health care industry's voluntary restraints (1978-1982) to forestall the Carter administration's hospital cost control legislation. Overall, the 1993 difference between the indexes (2.9%) is higher than the 2.1% average of excess medical care inflation over the 1966-1993 period.
- *The prescription drug index* of the medical care CPI also shows a three-year declining trend from 1990 (10%): 1991 (9.9%), 1992 (7.5%) and 1993 (3.9%) (Chart 3). The 1993 rate of price increase in prescription drugs is the lowest in 19 years (1974). Compared to the overall CPI, the

prescription drug index rose only 0.9% faster (3.9% vs 3.0%) in 1993 (Chart 4). This was the lowest rate of excess inflation since 1980. This chart also shows that prescription drug pricing policies changed markedly in the 1980s compared to the late 1960s and 1970s. For the entire 1966-1993 period, prescription drug prices averaged 0.1% per year faster than overall CPI inflation; the 1993 difference (0.9%) was thus still high by this historical measure.

- *The physician services index* is shown in Chart 5. The physicians' services CPI shows only a one-year decline from 1992 (6.3%) to 1993 (5.6%), although there is a general downward trend since 1989 (7.4%). The 1993 rate of physician price increase was the lowest in 20 years, since the 1973 price control year. In comparison to the overall CPI, the physicians' services price index, was also down from 1992, but rising 2.6% faster than the all-items CPI. This difference was significantly above the 1.9% average rate of excess physicians' services inflation for the 1967-1993 period.

- *The final set of charts shows the hospital and related services* index, reported since 1979. Chart 7 shows a four-year downward trend in this index growth since 1989 (11.5%): 1990 (10.9%), 1991 (10.2%), 1992 (9.1%), 1993 (8.4%). The 1993 rate is the lowest in six years (1987). A comparison between the hospital and related services index and the CPI shows that the 1993 excess hospital inflation (5.4%) is down only for one year, and remains significantly more inflationary than the overall medical care index and its physicians' services and prescription drugs components. (Chart 8) The 5.4% difference in 1993 is also significantly higher than the 4.6% average difference over the 1979-1993 period.

In summary, medical care price inflation has slowed over the past three years. In *nominal* terms, the medical care index, as well as its prescription drug and physicians' services components, are at or near record low rates of increase for the past 20 years. Yet, it is important to note that overall CPI inflation was also low in the last several years. In 1993, the difference between medical care inflation, as well as its physician services, prescription drug, and hospital and related services indexes components, and the overall CPI index was still about 0.5% to 0.8% per year greater than historical average differences between these indexes. In *relative* terms, medical care inflation in 1993 was still high by historical standards.

## HOSPITAL COST MEASURES (AHA)

The AHA quarterly panel survey provides tracking data for hospital revenues, costs and their components. These trends are shown, on an annual basis, in the first two charts on hospital costs per adjusted admission. Chart 9 shows that the rate of increase in hospital cost per adjusted admission declined between 1990 and 1994: 1990 (9.5%), 1991 (8.8%), 1992 (8.1%), 1993 (5.5%). The 1993 rate increase was the lowest since at least 1967 (26 years). The difference between the hospital cost increases and the CPI, shown on Chart 10, was 2.5% in 1993, compared to an average difference of 5.7% for the 1969-1993 period; the 2.5% difference was the lowest since the hospital "voluntary effort" period (1980). Chart 11 (prepared by ProPac) shows recent changes from the previous year's hospital costs by quarter; it indicates an accelerating slowdown since the second quarter of 1992; by the third quarter of 1993, the cost of a hospital admission was 4% higher than the previous year; adjusted for inflation, this was only 1% greater than for the same period a year earlier.

## INSURANCE PREMIUMS

Jon Gabel and colleagues, of KPMG Peat Marwick, have recently published results of a national study of health insurance trends, including self-insurance, that included a comparison with a national survey conducted in 1988.[1] Chart 12 summarizes their findings. It indicates that the inflation rate of health insurance premiums for fee-for-service (FFS), preferred provider organization (PPO), and health maintenance organization (HMO) plans were all declining over the 1989-1993 period. In 1989, the annual premium increases were 20%, 18%, and 16% respectively for these three types of plans; in 1993, the premium increases were 9.1%, 7.2%, and 7.7%—a reduction of more than half in the inflation rate. The next chart (Chart 13) indicates that a broad decline has also been true in real terms for a four-year period. Adjusted for inflation, FFS premium increases moderated from 15.2% to 6.1%, PPO plans from 13.2% to 4.2%, and HMOs from 11.2% to 4.7% over the 1989-1993 period.

Among the other difficulties in interpreting these premium increases, however, is that health care plan provisions changed rapidly. Average deductibles charged by FFS plans increased by 59% for individual coverage and 52% for family coverage over the 1988-1993 period, more than double the rate of inflation; over this period, PPO plans raised deductibles by 83% for preferred providers and 112% for non-preferred providers.

The KPMG Peat Marwick report also documents rapid shifts in types of insurance coverage enrollment, often cited as "structural change" in organization and competitive dynamics that may be important factors in the deceleration in health care inflation. As shown in Chart 14, different forms of managed care rapidly replaced traditional FFS plans as the dominant financing mechanism over the 1988-1993 period. In five years (1988 to 1993), FFS plans fell from a 71% to a 49% market share, while various forms of HMO, PPO, and POS (point-of-service) plans rose from 29% to 51% of employees. While 90% of employees were able to choose a conventional FFS plan in 1988, only 66% were able to do so in 1993.

Statistical evidence that the cost increases underlying health insurance, as well as health insurance premium increases, are declining is also reported by the *Health Cost Index Report*, published by John Cookson and colleagues at Milliman & Robertson. Their national tracking model for health care prices, utilization, and mix/intensity of services has shown 12-month average cost trends moving down from 12% annually at the end of 1990 to less than a 6% rate by third-quarter 1993. Nevertheless, their report also indicates marked regional variations in health insurance premium trends, with the national average for premium increases in the 12-month period ended September 30, 1993 at 5.4%, ranging from 1.0% in New England to 10.7% in the East South Central states. These regional variations are an important further caveat about generalizing from national sample data.

## NATIONAL EXPENDITURE TOTALS AND CBO FORECASTS

The latest official (DHHS) report on national health care spending is for 1991. Until these accounts are updated, there will continue to be uncertainty regarding what has been happening to national health care spending and its components over the past two years. In the interim, the Congressional Budget Office has continued to update its estimates and projections of national health care spending to provide a baseline for analyzing the potential impacts of health care reform legislation.

These CBO estimates were last updated in October, 1993.[3] They reflect a significant slowing of private health care costs from past trends over the past three years.

**Average Annual Growth Rate from Previous Year Shown**

| | 1965 | 1983 | 1987 | 1990 | 1993 (est) |
|---|---|---|---|---|---|
| **All Private Spending** | n/a | 11.2% | 7.9% | 10.9% | 7.7% |
| Health Insurance | | 14.3 | 8.6 | 12.7 | 9.2 |
| Out of pocket | | 8.4 | 7.5 | 7.8 | 5.8 |
| **GDP Growth** | | 9.2 | 7.5 | 6.7 | 4.3 |
| **Difference** | | 2.0 | 0.4 | 4.2 | 3.4 |

Also shown in the above table is a comparison between these spending trends and the ability to pay for them (GDP). The difference between the growth rate of private health care spending and GDP slowed somewhat—by about .8% annually—for the 1990-1993 period, compared to the previous three-year period. But private health spending was still growing about 3.4% annually faster than the GDP. Thus, even with the 1990-1993 slowing in health spending increases, health care has continued to become more expensive relative to the nation's ability to pay for it, and it has become relatively more expensive at a rate that is more rapid than average for the 1965-1993 period.

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1. Jon Gabel and Derek Liston. *Trends In Health Insurance*, KPMG Peat Marwick, January 1994. Also see Jon Gabel, et al. "The Health Insurance Picture, 1993: Some Rare Good News" *Health Affairs*, Spring 1994.

2. John Cookson, et al. *Health Cost Index Report*, Milliman & Robertson, Vol. 7, #1, January 1994.

3. Jeffrey Lemieux, et al. "Projections of National Health Expenditures: 1993 Update," Congressional Budget Office Memorandum, October 1993.

Chart 1

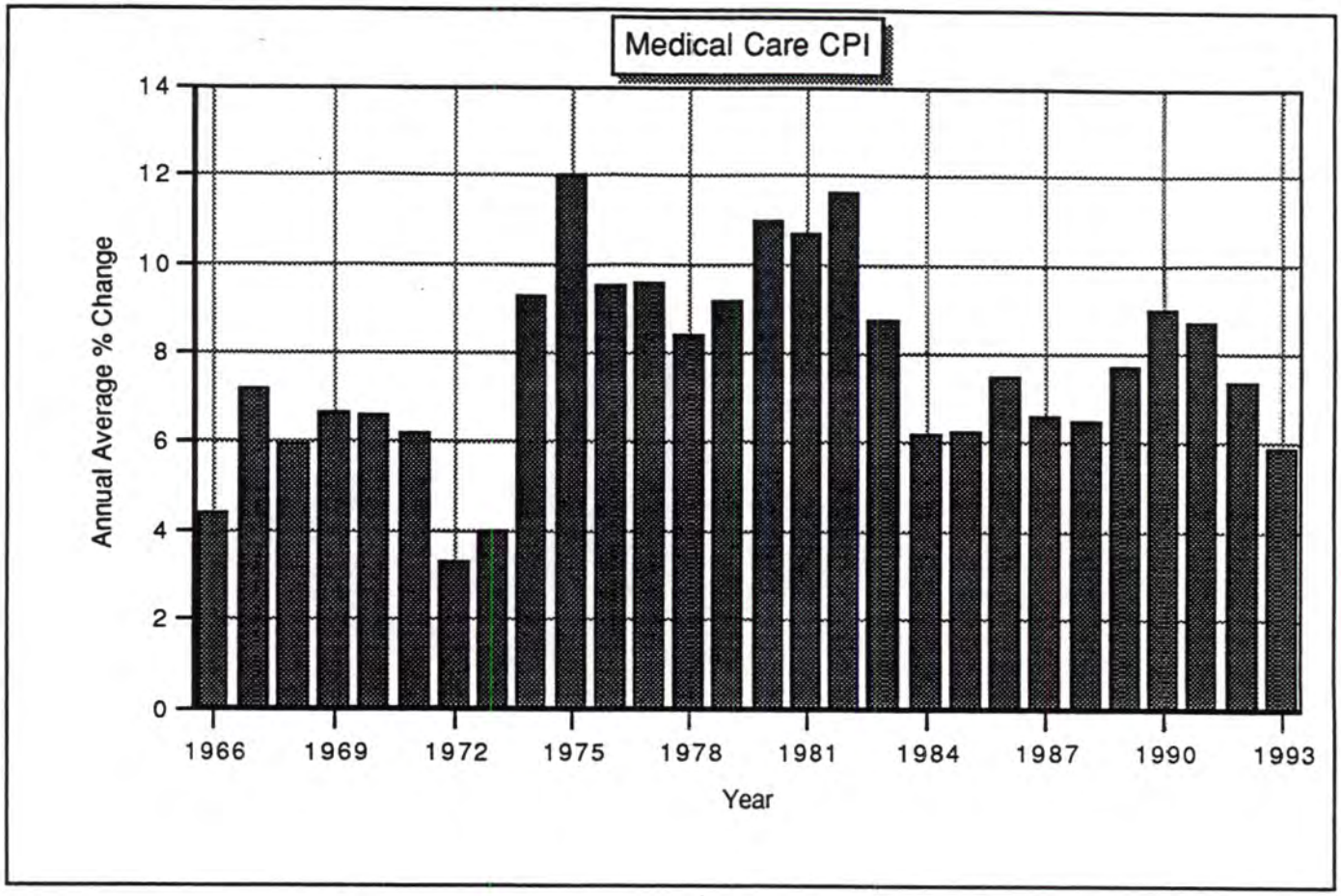


Chart 2

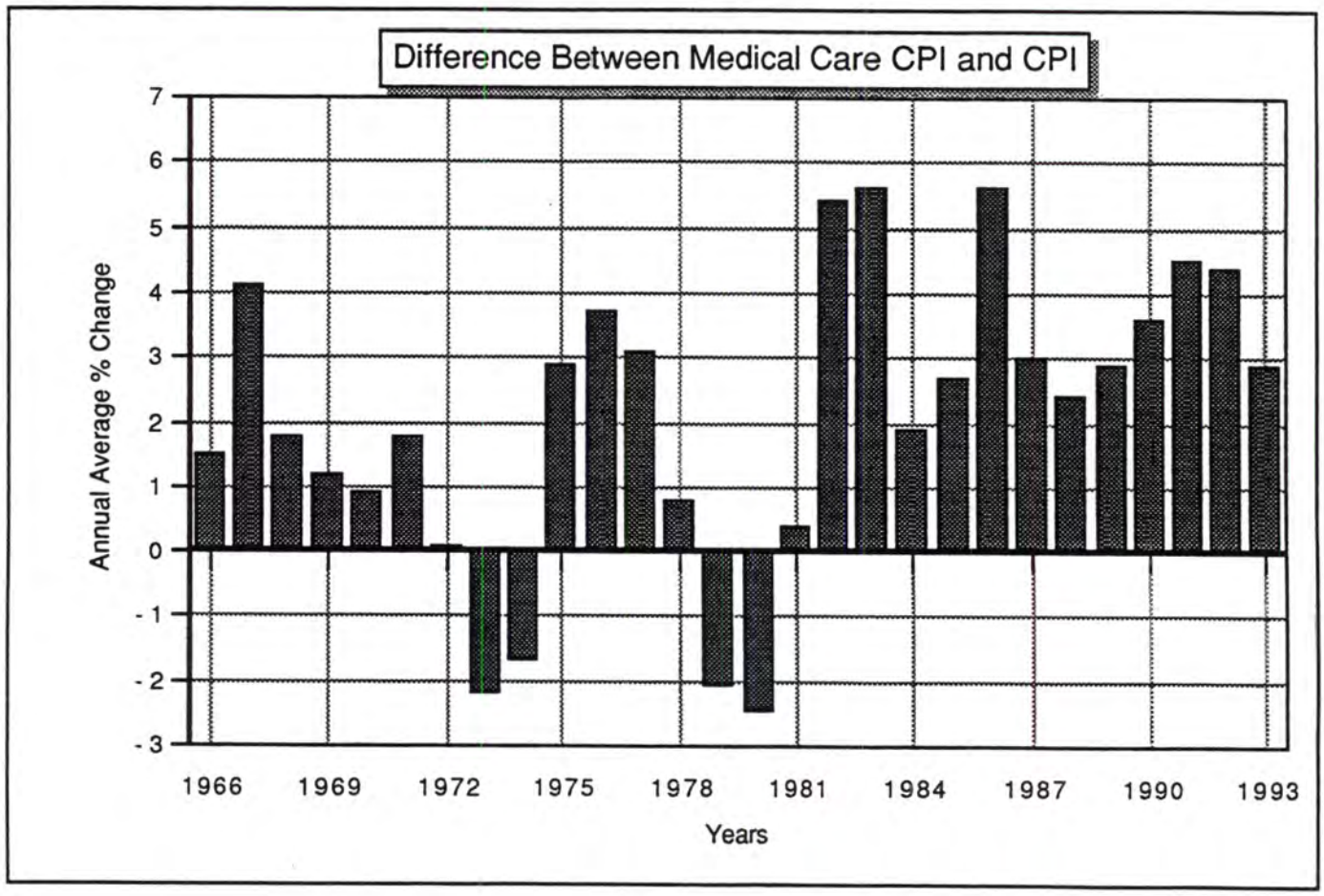

Chart 3

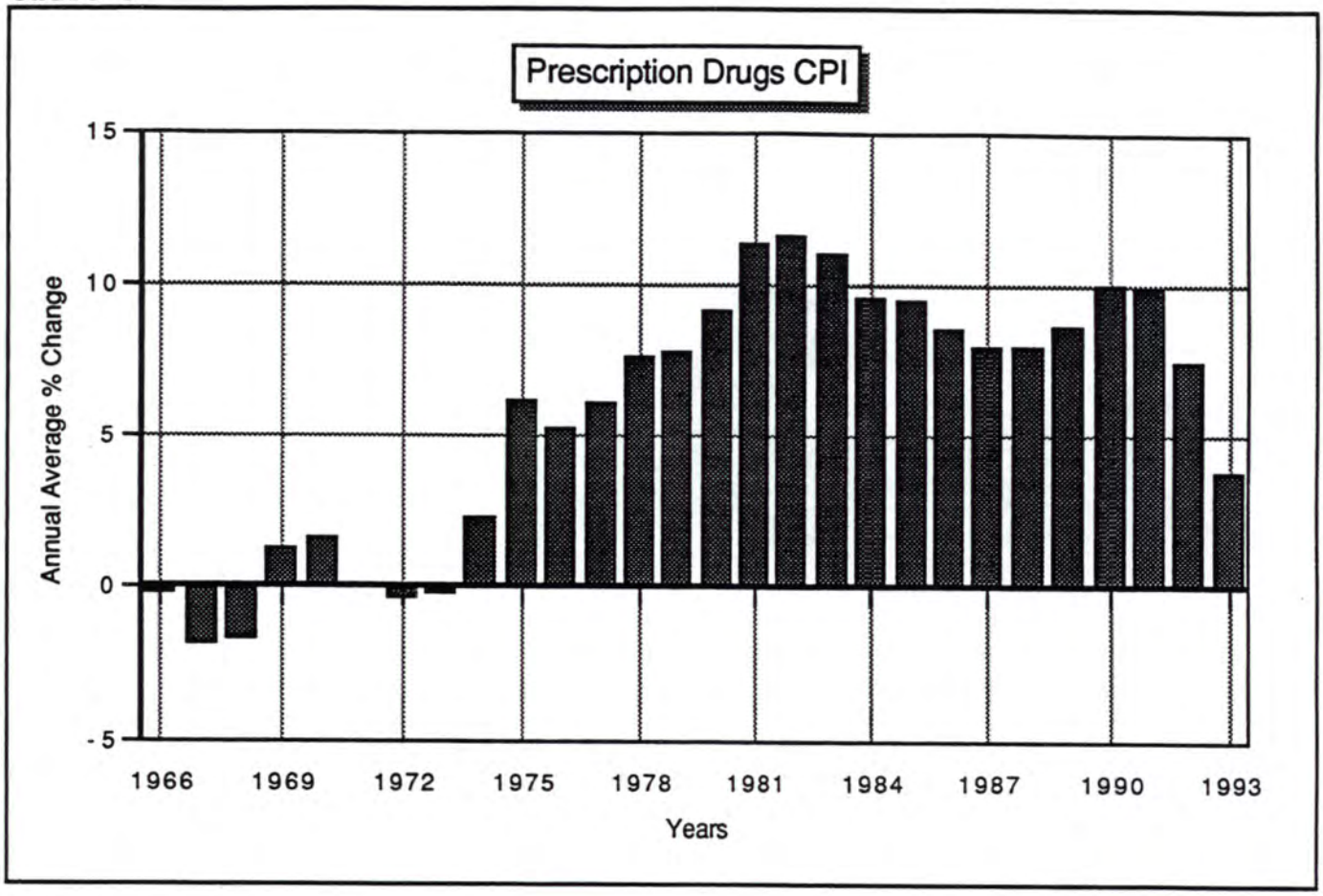


Chart 4

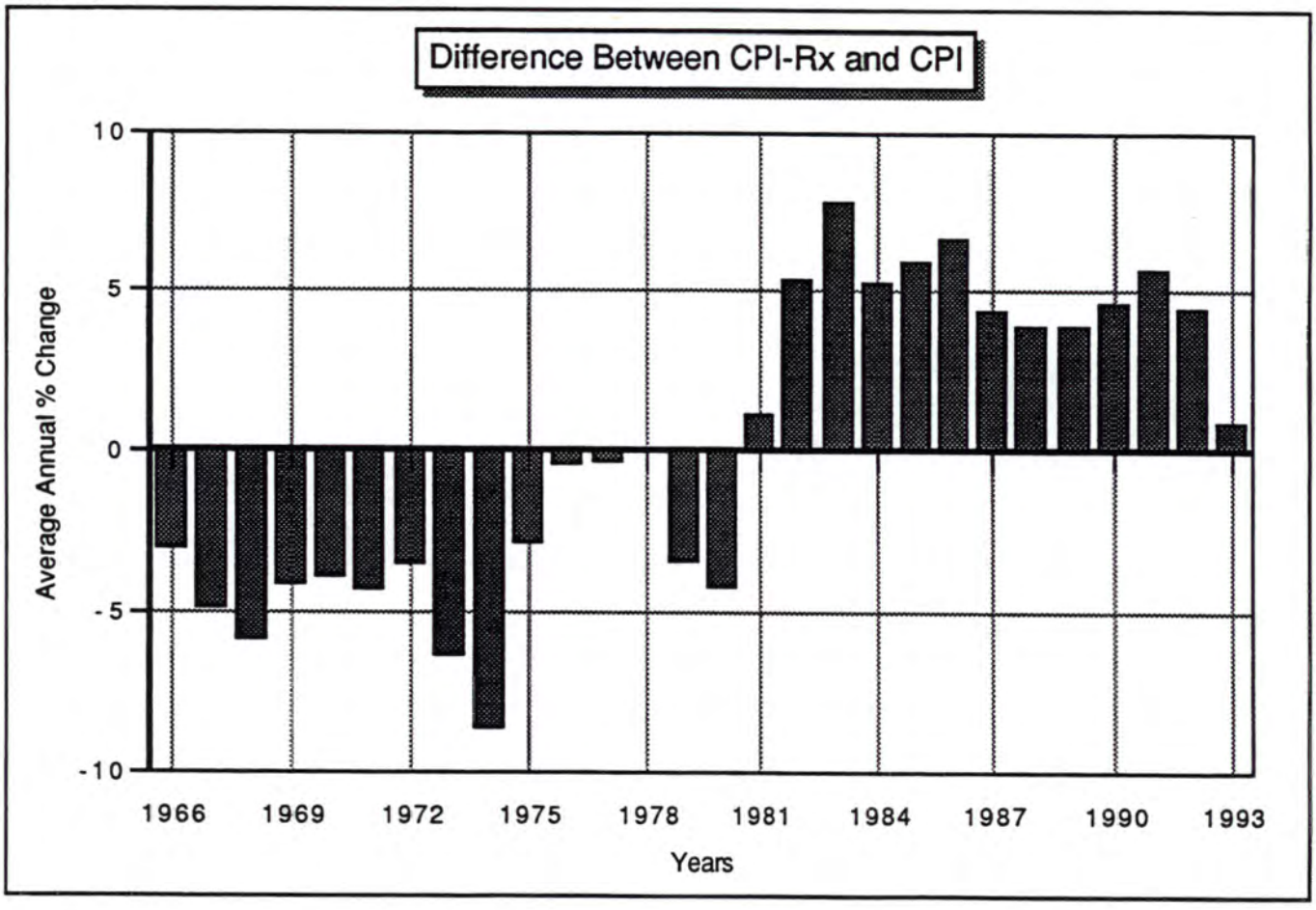

Chart 5

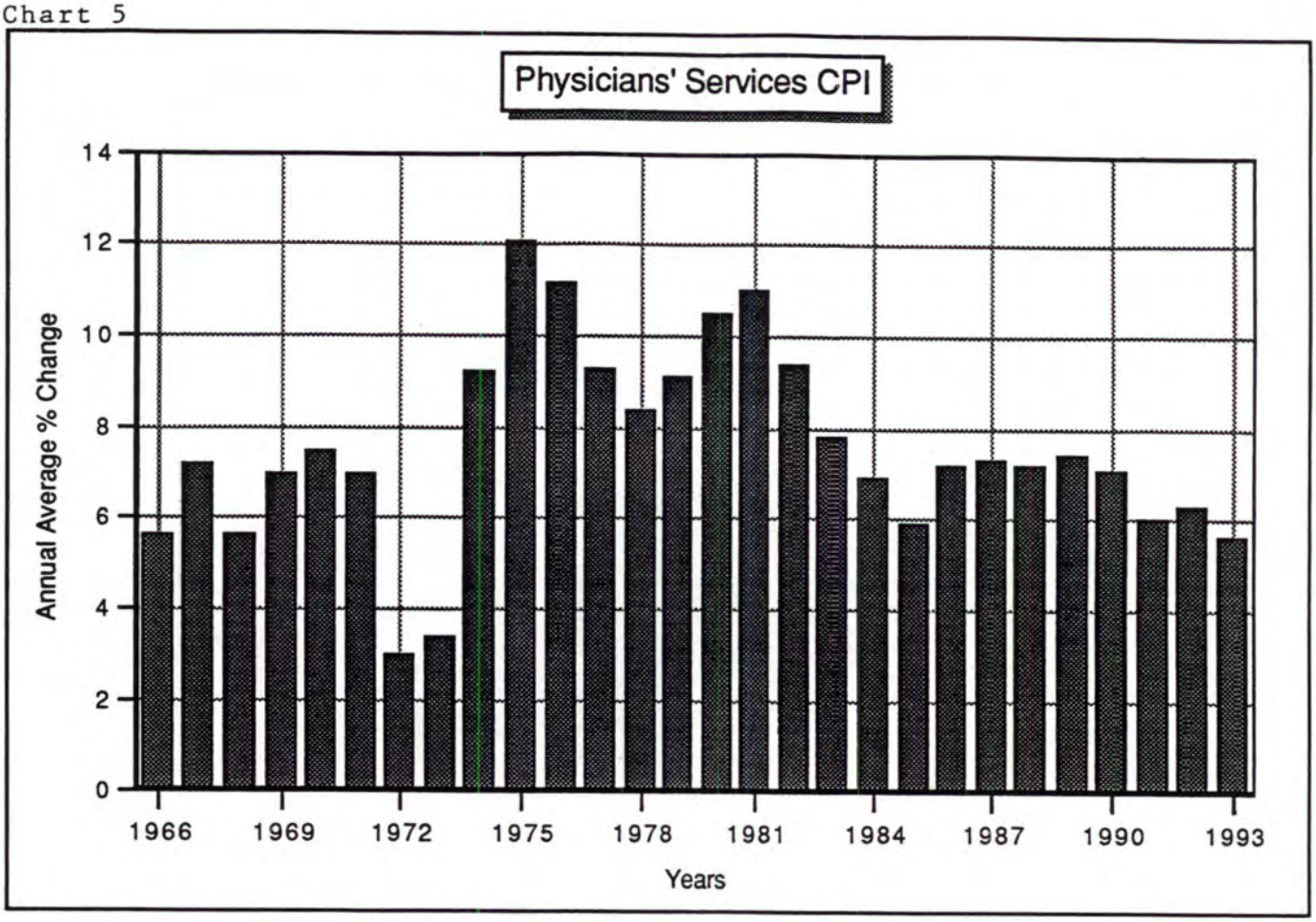


Chart 6

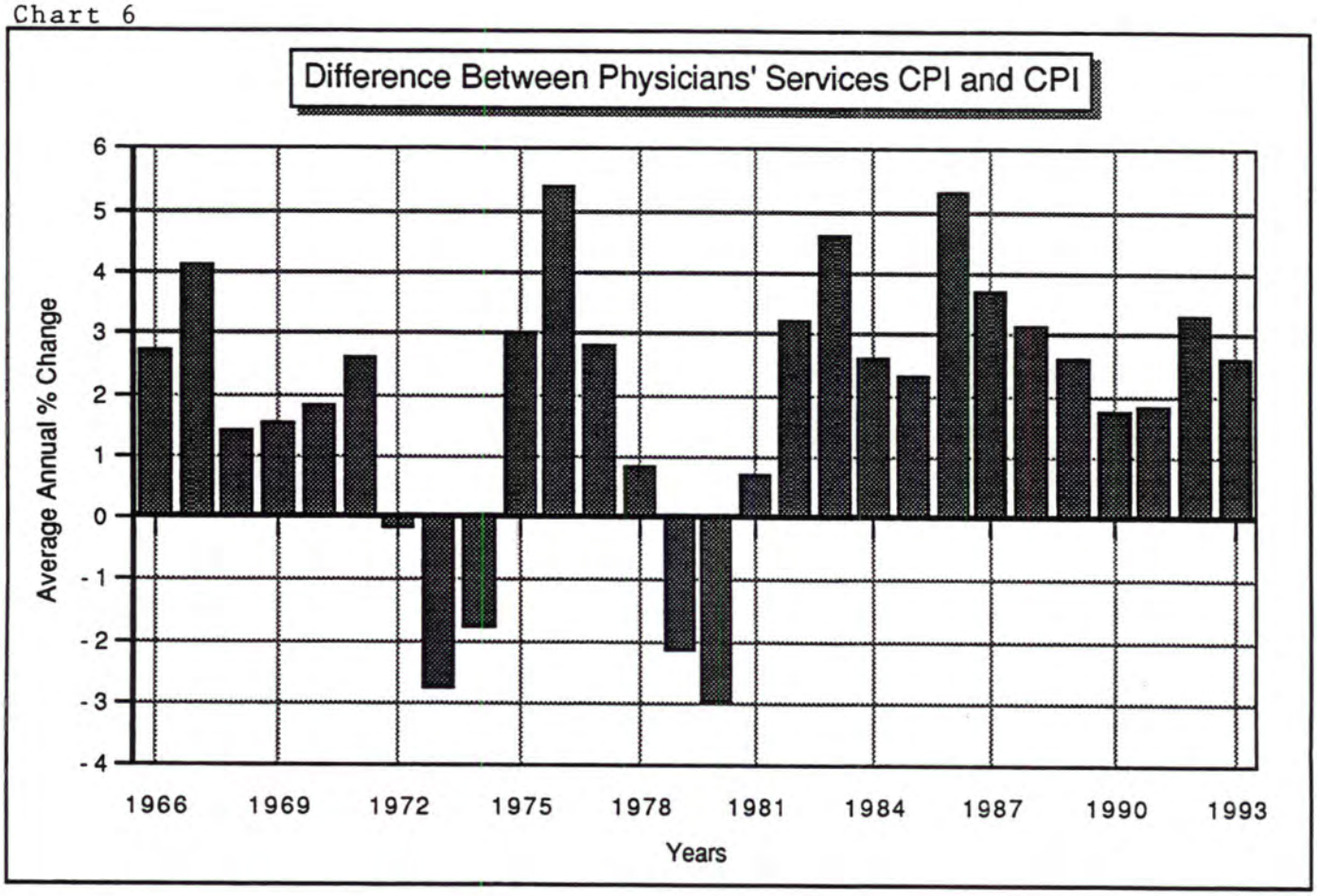

Chart 7

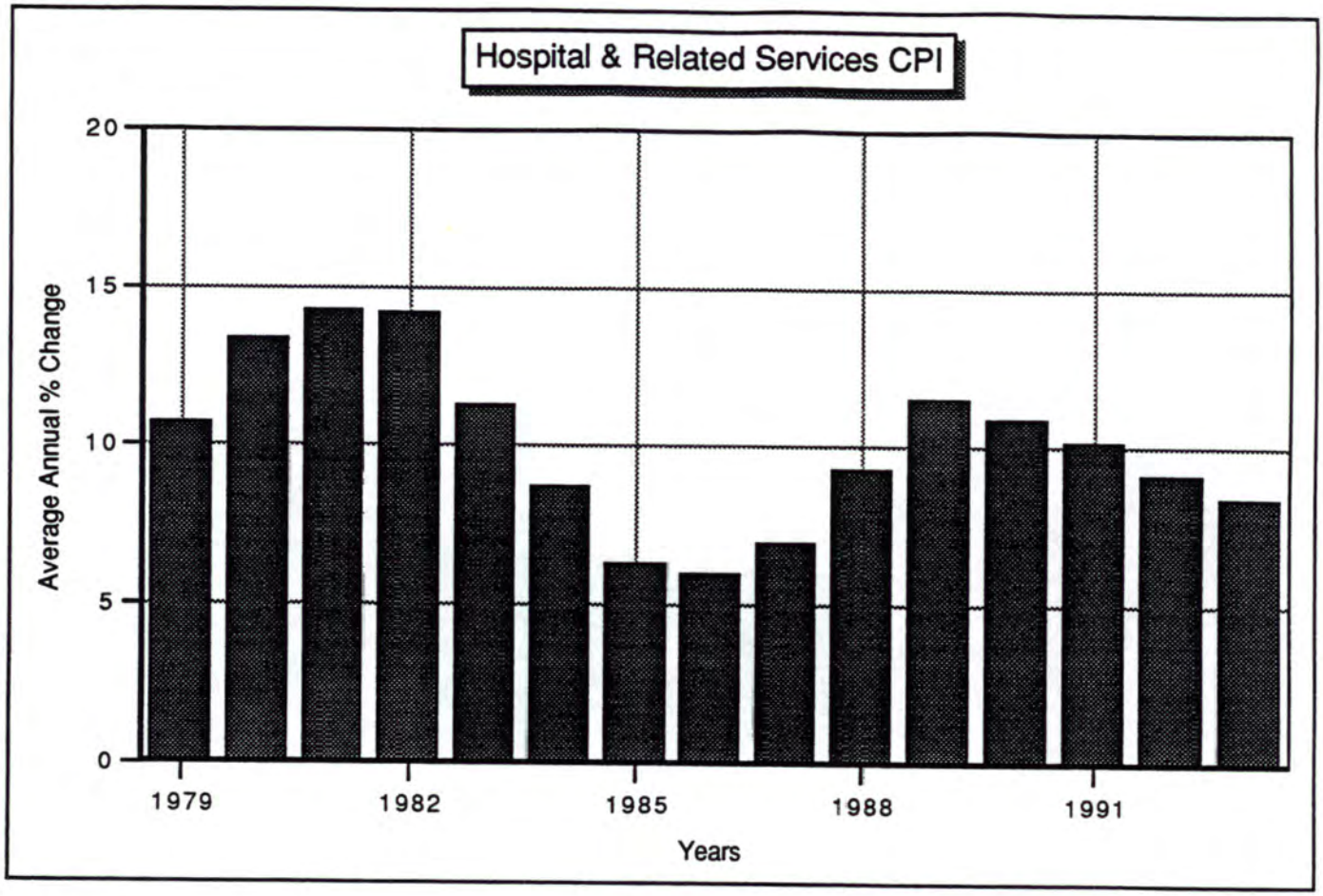


Chart 8

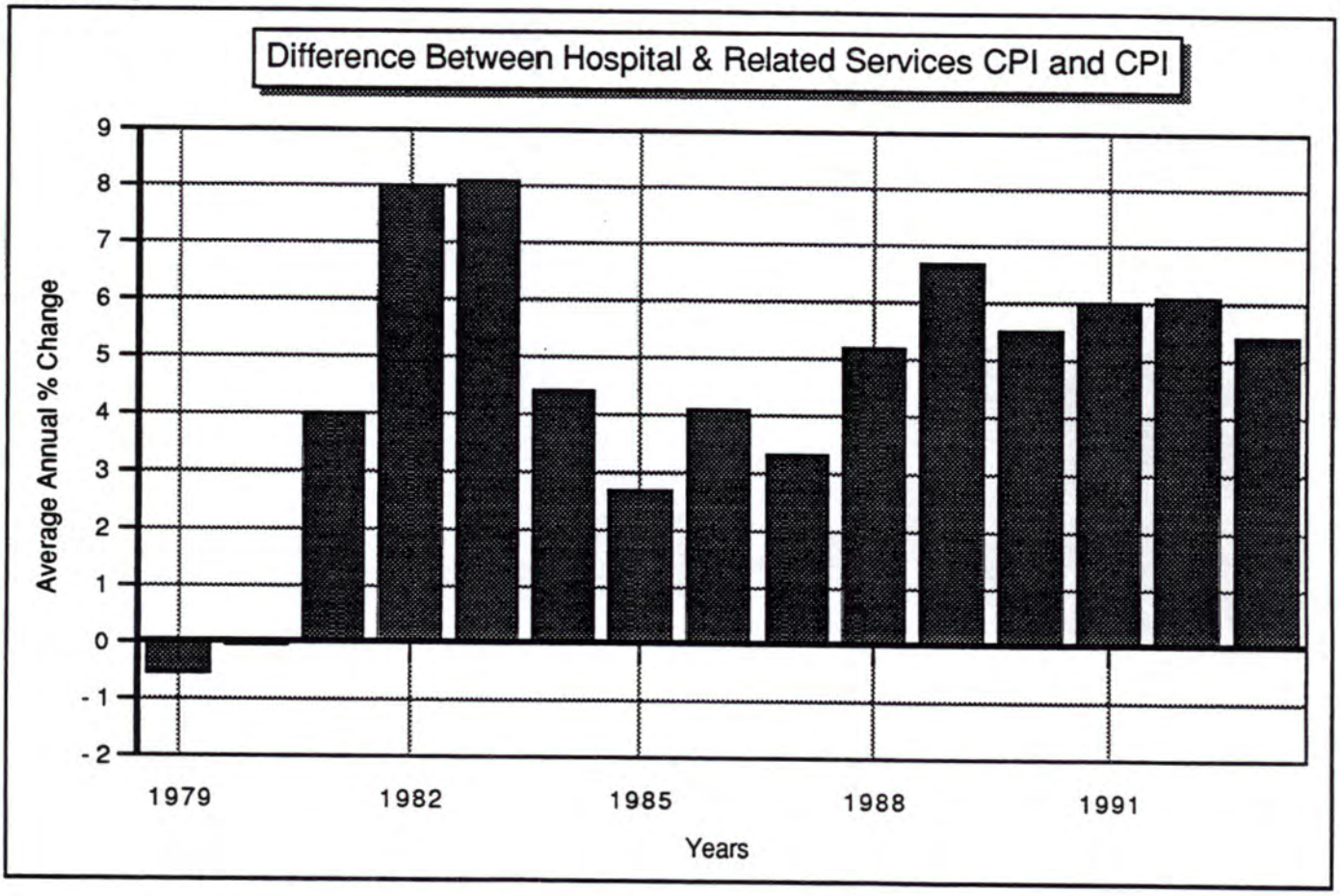

Chart 9

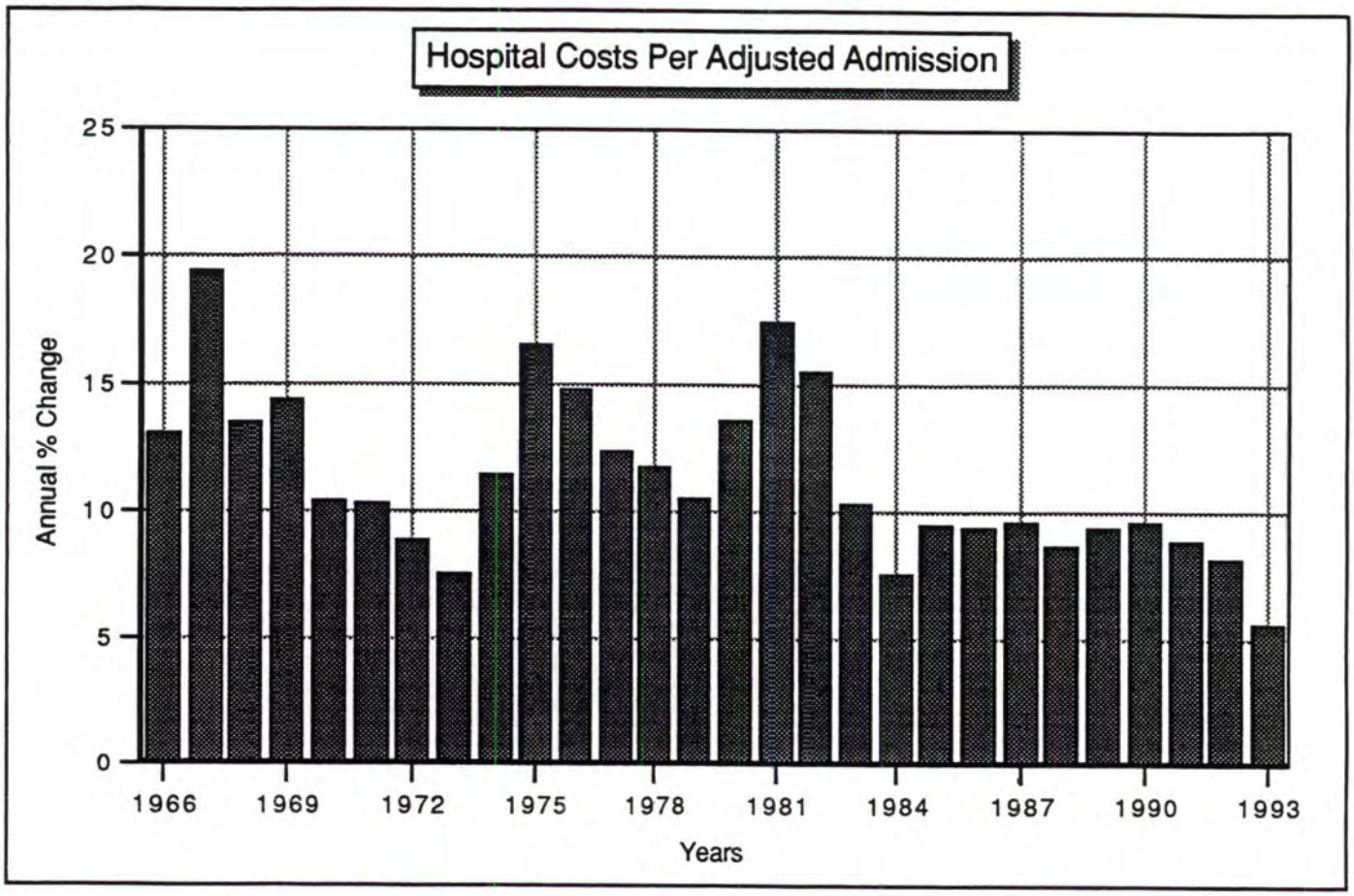


Chart 10

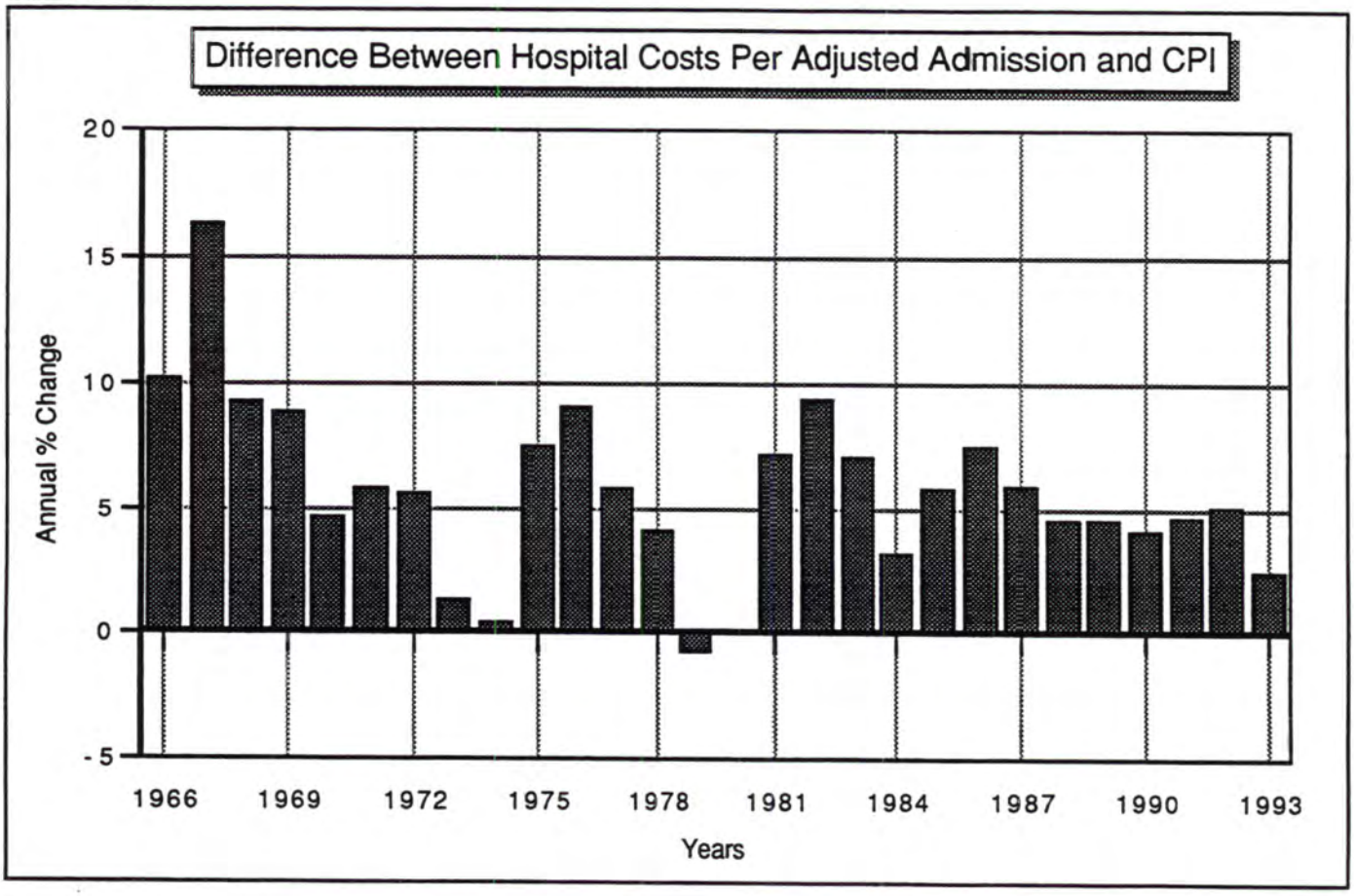

Chart 11

# QUARTERLY CHANGE IN HOSPITAL COST PER ADJUSTED ADMISSION

| | 1st Q 1992 | 2nd Q 1992 | 3rd Q 1992 | 4th Q 1992 | 1st Q 1993 | 2nd Q 1993 | 3rd Q 1993 |
|---|---|---|---|---|---|---|---|
| Nominal | 8.0% | 8.6% | 8.3% | 7.8% | 6.3% | 6.1% | 4.0% |
| Real | 4.9 | 5.4 | 5.1 | 4.7 | 3.2 | 3.0 | 1.0 |

Note: Each quarter compared to the same quarter the previous year.

SOURCE: AHA Panel Survey

Chart 12

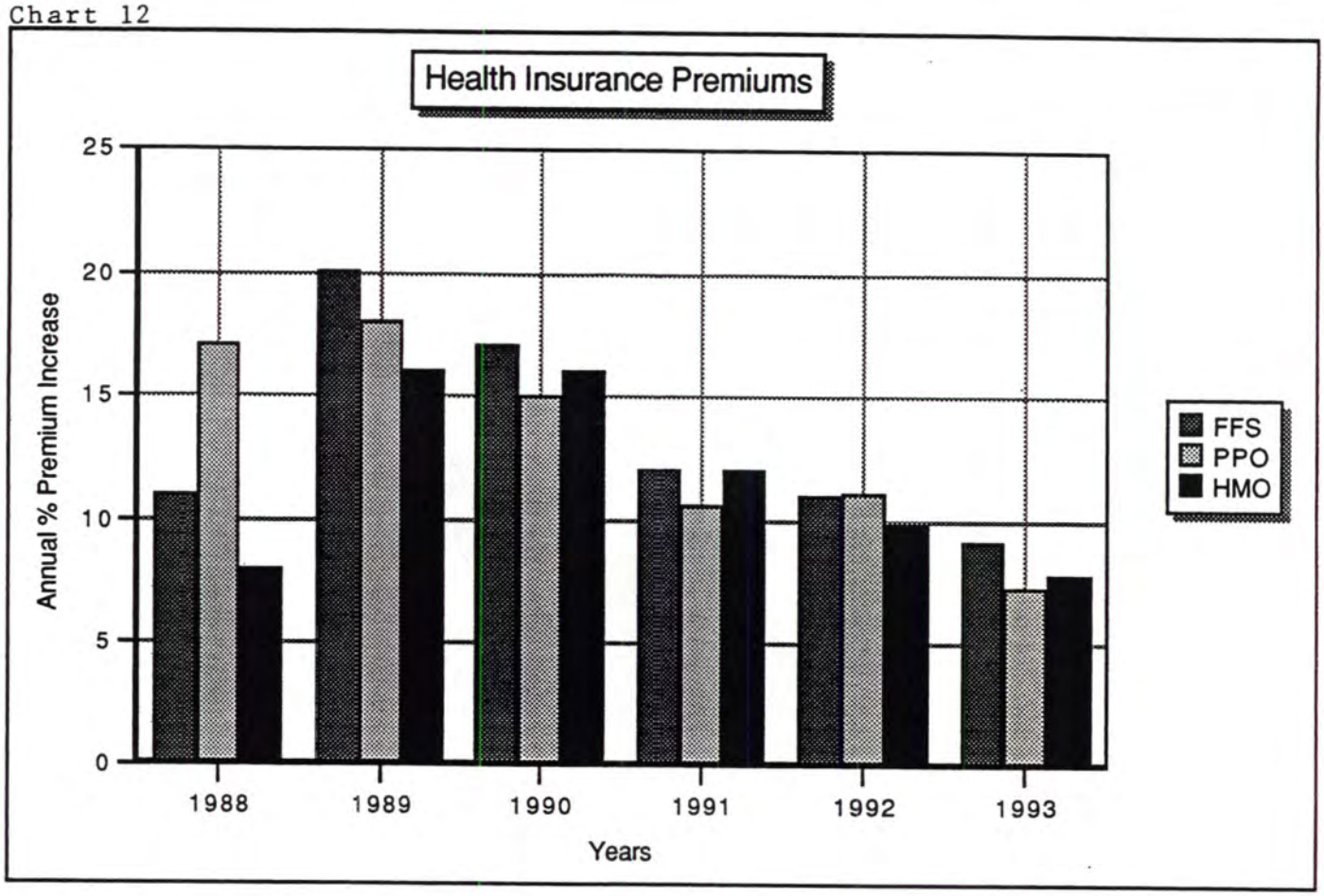


Chart 13

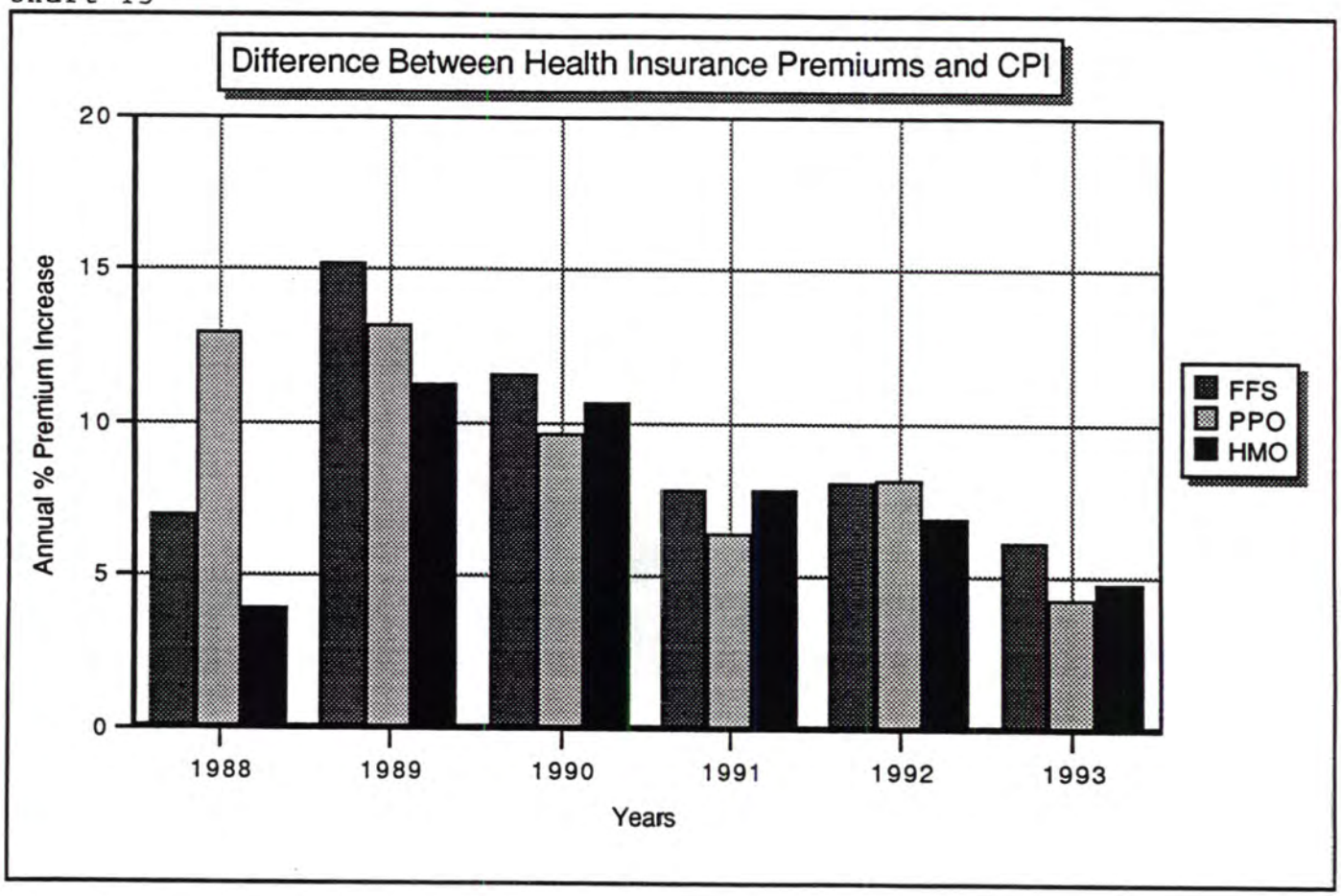

Chart 14

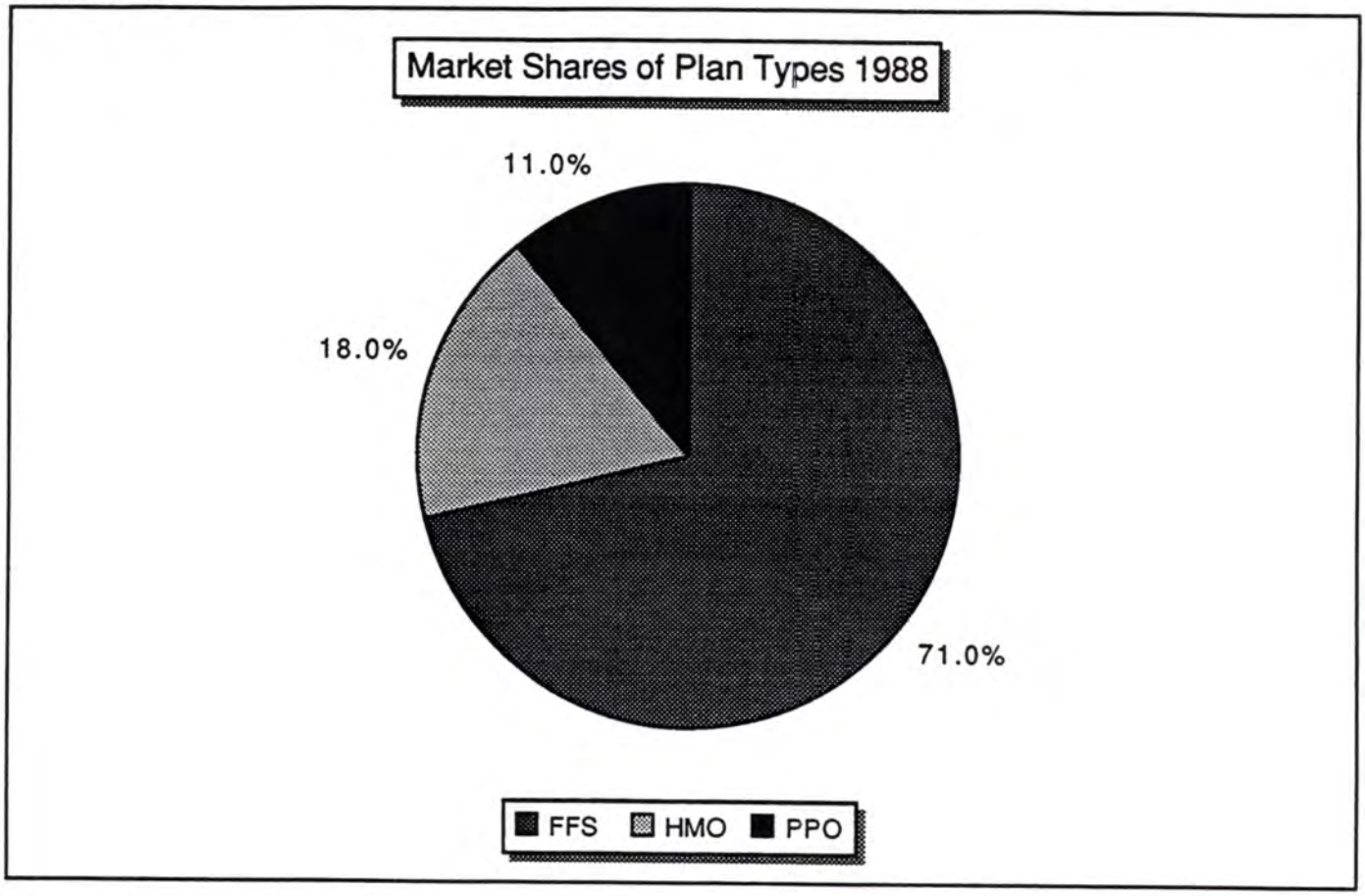


Chart 15