

Why Health Costs Are Still Rising

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Prices for medical services have been rising faster than prices of other goods and services for as long as anyone can remember. But not all health care prices are rising. Although health care inflation is robust for those services paid by third-party insurance, prices are rising only moderately for services patients buy directly.



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For example, the real (inflation-adjusted) price of cosmetic surgery fell over the past two decades — despite a huge increase in demand and considerable innovation.

Health Care Costs Rise When Others Pay. A primary reason why health care costs are soaring is that most of the time when people enter the medical marketplace, they are spending someone else's money. When patients pay their own medical bills, they are conservative consumers. Economic studies and common sense confirm that people are less likely to be prudent, careful shoppers if someone else is picking up the tab. Thus, the increase in spending has occurred because third parties — employers, insurance companies or government — pay almost all the bills.

The Extent of Third-Party Payment of Medical Bills. Most people pay for only a small portion of their medical care:

- For every \$1 worth of hospital care consumed, the patient pays only about three cents out of pocket, on the average; 97 cents is paid by a third party.
- For every \$1 worth of physician services consumed, the patient

pays less than 10 cents out of pocket, on the average.

- For the health care system as a whole, every time patients consume \$1 in services, they pay only 12 cents out of pocket.

Thus the incentive for patients is to consume hospital services until they are worth only three cents on the dollar, on the average. The incentive is to consume physicians' services until they are worth only 10 cents on the dollar. And for the health care system as a whole, patients have an incentive to utilize everything modern medicine offers until the value to them is only 12 cents out of the last dollar spent.

Medical Inflation. Health care costs over the past 40 years have risen as the proportion of health care paid for by third parties has increased. Prior to the advent of Medicare and Medicaid in 1965, health care spending never exceeded 6 percent of gross domestic product. Today it is 17 percent. There has been an increase in tax-subsidized employer spending on health care. These two factors, rather than the cost of new technology and drugs, explain why health care costs outpace inflation.

Cosmetic Surgery Prices. Cosmetic surgery is one of the few types of medical care for which consumers pay almost exclusively out of pocket. Even so, the demand for cosmetic surgery has exploded in recent years. According to the American Society of Plastic Surgeons, 1.7 million cosmetic surgical procedures were performed in 2008. That is more than

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40 times the number performed two decades ago (for example, 413,208 in 1992).

Despite this huge increase, cosmetic surgeons' fees have remained relatively stable. Since 1992, medical care prices have increased an average of 98 percent. The price of physician services rose by 74 percent. [See the figure.] The increase in the price of all goods, as measured by the consumer price index (CPI), was 53 percent. Yet, an index of cosmetic surgery prices only rose only about 21 percent. Thus, while the price of medical care generally rose almost twice as fast as the CPI, the price of cosmetic surgery went up less than half as much. Put another way, while the real price of health care paid for by third parties rose, the real price of self-pay medicine fell.

As the figure shows, during downturns in the economy consumers become more price sensitive and providers respond accordingly with more competitive prices. Notice this phenomenon did not occur for medical care or physician services.

Keeping Costs Down. What explains this price stability? One reason is patient behavior. When patients pay with their own money, they have an incentive to be savvy consumers. A second reason is supply. As more people demanded the procedures, more surgeons began to provide them. Since almost any licensed medical doctor may obtain training and perform cosmetic procedures, entry into the field is relatively

easy. A third reason is efficiency. Many providers have operating rooms located in their clinics, a less expensive alternative to outpatient hospital surgery. Surgeons generally adjust their fees to stay competitive and usually quote patients a package price. Absent are the gatekeepers, prior authorization and large medical office billing staffs needed when third-party insurance pays the fees. A fourth reason is the emergence of substitute products. (See below.)

Cosmetic Surgery and Innovation. A common perception is that innovations increase the cost of health care. But in cosmetic surgery, innovation often lowers the cost. Take facelifts, for example. Surgical fees for facelifts increased about 54 percent between 1992 and 2009 (about the same as inflation), according to data from the American Society of Plastic Surgeons.

Cheaper, minimally invasive and nonsurgical procedures designed

to reduce the appearance of aging have helped hold the cost of facelift surgery in check. Laser resurfacing (\$2,193) can replace or delay surgical facelifts in some patients. Botox injections (\$405), collagen injections (\$480), chemical peels (\$764), dermabrasion (\$1,123) and fat injections (\$1,647) are other facelift alternatives. These less invasive (and less expensive) procedures may be attractive compared to a facelift costing \$6,396 in surgeons' fees alone.

Cosmetic surgeons also have incentives to find new products to meet customer needs. Laser hair removal and body contouring, for example, are now common.

Conclusion. The contrast between cosmetic surgery and other medical services is important. One sector has a competitive marketplace and stable prices. The other does not.

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