



BRIEF ANALYSIS

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Update 2006: Why Are Health Costs 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. For example, the real (inflation-adjusted) price of cosmetic surgery fell over the past decade — 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. Although polls show that many people fear they will not be able to pay their medical bills from their own resources, the reality is that 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 14 cents out of pocket.

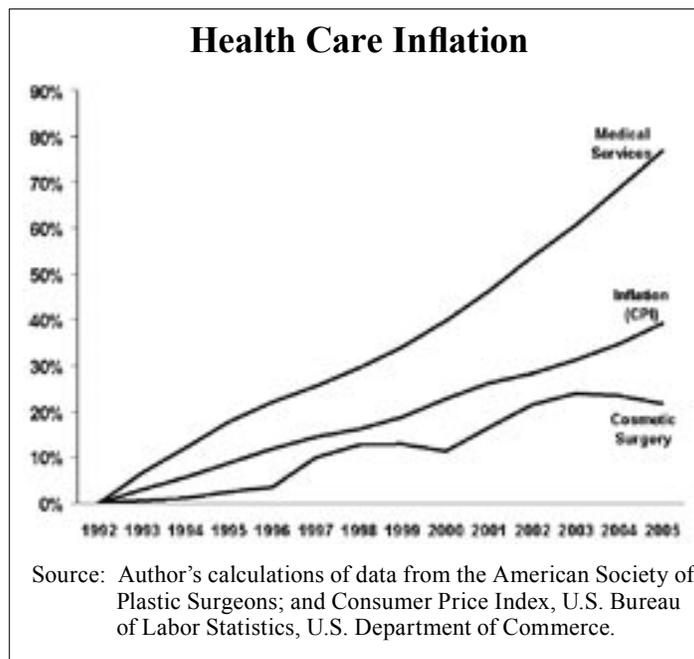
Thus the incentive for patients is to consume hospital services until they are worth only three cents on the dollar, on the average. The incentive is to consume physicians' services until they are worth only 10 cents on the dollar. And for the health care system as a whole, patients have an incentive to utilize everything modern medicine offers until the value to them is only 14 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 16 percent. These two government programs unleashed a torrent of new spending and led to rising health care prices. For instance, a recent study by Amy Finkelstein of the Massachusetts Institute of Technology found that half the growth in health care expenditures was due to Medicare. There has also 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 exploded in recent years. Of the 10.2 million cosmetic procedures performed in 2005 that were tracked by the American Society of Plastic Surgeons, 1.8 million were surgical procedures. By comparison, in 1992 the American Society of Plastic Surgeons only tracked 413,208 cosmetic procedures — a fraction of those performed in 2005.



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Despite this huge increase, cosmetic surgeons' fees remained relatively stable. The average increase in prices for medical services from 1992 through 2005 was 77 percent. [See the figure.] The increase in the price of all goods, as measured by the consumer price index (CPI), was 39 percent. Cosmetic surgery prices only went up about 22 percent. Thus, while the price of medical services generally rose almost twice as fast as the CPI, the price of cosmetic surgery went up slightly more 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.

Another example of price competition is the market for corrective eye surgery. In 1999, only a few years after LASIK was approved, the price was about \$2,100 per eye, according to the ophthalmic market research firm MarketScope. Within a short time, competition drove the price down to a slightly more than \$1,600. The cost per eye of the standard LASIK is now about 20 percent lower than six years earlier. Competition held prices in check until a new innovation arrived for which patients were willing to pay more. By 2003 surgeons began to perform a newer, more-advanced custom wavefront-guided LASIK procedure.

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.)

Fostering Competition. Web sites help create a competitive market for cosmetic procedures. One, www.Bidforsurgery.com, is a reverse auction site that works

much like eBay. Physicians submit competitive bids to perform procedures. The potential patient compares bids and quality indicators — information on residency, education, board certifications and so forth. Patients can select a bid from among those physicians bidding or reject them all. If the patient chooses one of the bids, he or she gets a free consultation with the selected physician before making a final commitment.

Web sites like MedRetreat.net and PlanetHospital.com connect patients with foreign clinics where high-quality procedures are available at much lower prices than in the United States, even including the cost of patient travel. These Web-based middlemen only arrange procedures with doctors and facilities they have vetted and deemed to provide high-quality care.

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 less than 8 percent between 1992 and 2005 (which in real terms is a price reduction), 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. Thread lifts (\$2,469) and laser resurfacing (\$1,977) can replace or delay surgical facelifts in some patients. Botox injections (\$363), collagen injections (\$390), hyaluronic acid (\$557), chemical peels (\$628), dermabrasion (\$872) and fat injections (\$1,174) are other facelift alternatives. These less-invasive (and less-expensive) procedures may be attractive compared to a facelift costing \$4,484 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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