Estimate of the Situation

Critical Information for Critical Times, Edition of Wednesday, June 11, 2014

Demystifying Health Care Finance, Part I

As was observed here last week, if there is no common agreement on the meaning of the words used to describe an issue, those words can't be used to resolve the issue. No topic under public discussion provides a better example of this than the ongoing debate over "health care costs" and how to control them. To circumvent this issue, let's first define our terms.

Although a case can be made for including health education and preventative measures in the definition, for most people "health care" simply means the physician-directed diagnosis and treatment of illness or injury in a doctor's office or hospital. It's in the discussion of "costs" and the virtually non-existent connection between costs and hospital charges that confusion arises.

In addition to being the primary cause of rapidly escalating hospital costs, the Third Party Payer System's absurdly irrational methods are a public relations disaster for hospitals and physicians. For some reason, people find it off-putting that at least 40% of a hospital's generated charges will either not be paid at all—or, worse, that the costs underlying those charges will be shifted to patients who had nothing to do with their generation.

Consider this apparently logical (and partially accurate) breakdown of "health care costs".

- First there are unit costs. These are the real costs of providing episodes of care to actual patients. This is what most people *think* they are discussing when they speak of health care costs.
- Then there are aggregate costs. This is the sum of program costs to insure a defined population against unit costs. This is what most employers and government officials *think* that the topic of health care costs is all about.

Unfortunately, it's not quite that simple. The real unit costs incurred by a hospital to provide an episode of care to an actual patient aren't that much of a problem—or at least they wouldn't be if hospitals operated under what the rest of the world considers "normal business conditions". Real unit costs include the costs of the items that people pretty much expect, such as the salary, wages and benefit costs of hospital care givers and the cost of supplies used to deliver care. They also include the allocated indirect but real costs of expense items not separately billed such as depreciation and other operating expenses for plant maintenance, housekeeping, food service, etc.

The Third Party Payment System is the problem. Its very existence imposes tremendous costs upon hospitals, most of which are completely invisible to the public and not understood at all. Those rapidly metastasizing costs, which are in addition to the real unit cost of care to a specific actual patient, have reached the point where they now account for at least 40% of an average hospital patient's generated charges. These additional costs include, among other things, the unreimbursed portion of the cost of care provided to ACA, Medicare, Medicaid, HMO, PPO, and other patients; the cost of mandated Third Party record keeping requirements (including the Electronic Health Record, "meaningful use", and ICD-10 implementation); other coding and billing requirements; and the cost of providing mandated uncompensated hospital care such as that required under EMTALA. Moreover, there is a significant amount of elasticity in the demand for primary care. When the consumer of a desirable good or service is insulated from the cost of making the consumption decision, demand for that service will expand exponentially. This fundamental economic principle generates many hospital Emergency Department and walk-in visits, a substantial portion of which are clinically unnecessary. To the extent those visits are clinically unnecessary, so are the associated costs.

The Third Party Payment System is damaging business profitability, driving physicians from the practice of medicine, bankrupting hospitals, destroying rural economies, imperiling the solvency of many state governments, and even threatening the national economy. When the system's costs outweigh the system's benefits, that is a very big deal and that is where we now find ourselves.

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