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COMPETITIVENESS BRIEF

Washington Alliance for a Competitive Economy

CB 08-01 April 03, 2008

RECENT TRENDS IN HEALTH CARE SPENDING

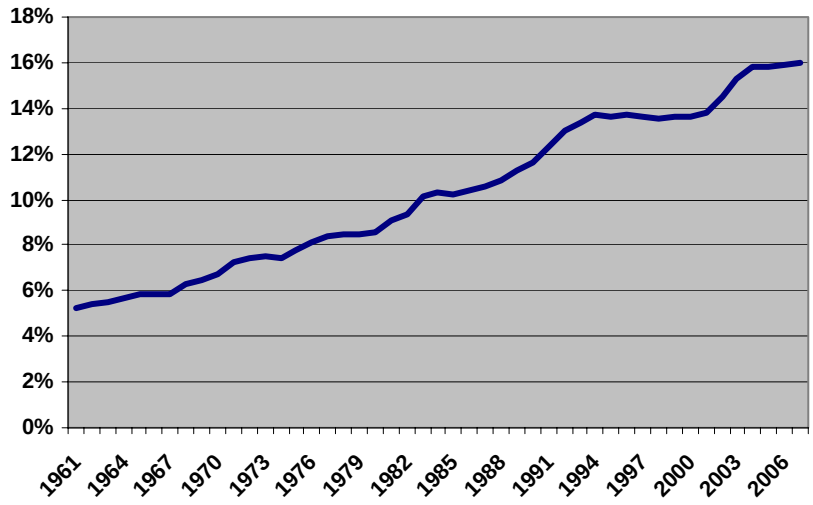
BRIEFLY

Health care spending grew 6.7 percent in 2006 to $2.1 trillion or $7,026 per person. This brief looks at several reports on the state of national health care spending as well as the impact of Medicare Part D in 2006.

Recent updates to the National Health Expenditure Accounts indicate that U.S. health care spending totaled $2.1 trillion in 2006, $7,026 per person or 16.0 percent of GDP. While many cost drivers have decelerated, health care spending continues to grow at a faster rate than GDP. Spending has been spurred by an aging population and the implementation of Medicare Part D, which boosted retail prescription drug sales in 2006.

The shares of household and government spending have changed dramatically in the last 20 years. The household share of spending for health services and supplies fell from 40 percent in 1987 to 31 percent in 2006. The share accounted for by governments increased from 30 percent to 40 percent in the same time frame. This is largely attributed to the expanded roles of Medicare and Medicaid. In contrast, businesses share of health spending has remained fairly constant at between 25 and 27 percent.

Figure 1: National Healthcare Spending as a Percentage of GDP



Washington's per capita health expenditure grew an average of 5.6 percent per year between 1991 and 2004 (the most recent year for which state-level data are available). This was slightly faster than the U.S. average of 5.5 percent per year. Healthcare spending growth in Washington seems to have accelerated in the latter half of this period, growing an average of 4.2 percent (0.6 percent below the national average) between 1991 and 1998 and then accelerating to 7.3 percent between 1998 and 2004, far outpacing the U.S. average of 6.3 percent for the latter sub-period.

Economists at the Center for Medicare and Medicaid Service's National Health Statistics group project that national health spending will grow at an average annual rate of 6.7 percent through the year 2017, and absorb 19.5 percent of GDP in that year.

National Health Care Spending

Health care spending grew 6.7 percent in 2006 to $2.1 trillion or $7,026 per person. This was an acceleration of 0.2 percent from 2005, which experienced the slowest growth since 1999. Health care absorbed 16 percent of GDP in 2006, roughly the same share as 2003. The relative stability of health care's share is attributable to slower health care spending growth

as well as strong U.S. economic growth (Catlin et al., 2008).

Figure 1 shows the growth in national health expenditure as a percent to GDP since 1961. In 1961 national health expenditure accounted for close to 5 percent of GDP. The share steadily increased until the mid-90s when it leveled off: In 1995, national health expenditure totaled $990.2 billion, just under 14 percent of GDP. Sharp increases occurred from 2000 to 2003, eventually leveling off at just under 16 percent.

The Center for Medicare and Medicaid Services (CMS) now predicts an average annual growth rate of 6.7 percent for health care spending between 2007 and 2017. Health care spending is projected to reach $4.3 trillion in 2017 and to account for 19.5 percent of GDP (Keehan et al., 2008).

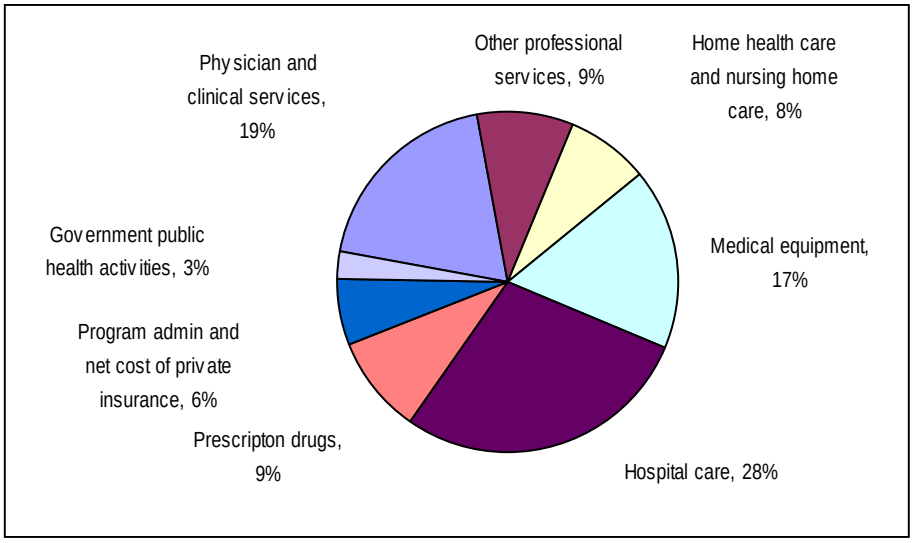
The growth in personal health care (PHC) spending (the portion of national health spending that accounts for health care goods and services) decelerated slightly from 6.8 percent in 2005 to 6.6 percent in 2006. Excluding prescription drugs, which saw increased growth for reasons we discuss below, the slowdown is even more pronounced, going from 7 percent in 2005 to 6.3 percent in 2006.

Expenditure

Other than prescription drugs, most major health sectors experienced slower growth in 2006 than in 2005. Health care price growth accounted for more than one-half of the growth in health care spending, population growth accounted for about one-sixth, and changes in the use and intensity of medical care services per person accounted for most of the remaining one-third (Catlin et al., 2008).

Figure 2 breaks down health services and supplies expenditure by category. (Health services and supplies spending is equal to national health expenditure less investment in research, structures and equipment).

Figure 2: Health Services and Supplies by Sector



Hospitals. In 2006, $648.2 billion was spent on hospitals. This accounted for nearly 31 percent of total health care expenditure. Spending grew by 7.0 percent, which was a deceleration of 0.3 percent from 2005's growth.

Growth in the use of hospital services remained low, but hospital price growth accelerated. Hospital prices (as measured by the Producer Price Index) increased 4.4 percent in 2006 compared to 3.8 percent in 2005. This acceleration occurred even though the underlying cost of providing hospital services grew by less in 2006 than in 2005, in part due to slower price growth in non-compensation costs such as malpractice insurance.

Medicare inpatient spending growth slowed due to a decrease in fee-for-service patient admissions, while Medicaid hospital use slowed in part due to slower enrollment growth. Medicare spending growth for hospitals is expected to accelerate to 8 percent per year by 2017 (Keehan et al., 2008).

Hospital expenditure accounted for 28 percent of total health care spend-

ing growth between 2000 and 2003 and 27 percent of growth between 2003 and 2005. Hospital spending growth is expected to decline from 7.2 percent in 2008 to 6.4 percent in 2017.

Physician and clinical services. Physician and clinical services is the second largest category of health spending, accounting for 21.3 percent of national health care expenditure. This category grew 5.9 percent in 2006 to $447.6 billion, its slowest rate of growth since 1999, contributing to the PHC slowdown. This is also well below the 6.6 percent average annual growth rate between 1995 and 2006; 5.9 percent is expected to be the average annual growth for the 2007 to 2017 period. Physician prices (measured by the National Health Expenditure Accounts) increased 1.8 percent in 2006, which was 1.5 percent slower than 2005. This is partly attributed to the freeze in the Medicare conversion factor for physician services in 2006.

Nursing home and home health. Nursing home spending growth decreased in 2006 to 3.5 percent, its lowest level since 1999 and down from 4.9 percent in 2005. This deceleration is attributable in part to a slowing in nursing home price growth. Prices grew by 3 percent in 2006, 0.7 percent less than in 2005. In addition, the continued movement of people out of institutions to home and community-based care also contributed to the slowing growth. Medicare and Medicaid accounted for 60 percent of total nursing home spending.

Home health care continues to be the fastest growing component of PHC spending. It is expected to grow an average of 7.7 percent per year from 2007 to 2017, although the impact of this is limited by the fact that home health care accounts for only 2.5 percent of total spending.

Figure 3: National Health Spending by Sector

Prescriptions. Growth in retail drug spending accelerated to 8.5 percent in 2006 from 5.8 percent in 2005, the slowest rate of growth in drug spending since 1977. Despite the accelerated growth rate, the increase was still far below the 1995 to 2004 average annual rate of 13.4 percent and well below the growth rate of 11.6 percent that CMS had projected (Poisal et al.

Spending Category	2006 Total ($ billions)	Per capita ($)	% Total NHE	% GDP
NHE, billions	**2105.5**	**7,025.36**	**100.00%**	**15.96%**
Health services and supplies	1966.2	6,560.56	93.38%	14.90%
Personal health care (PHC)	1762.0	5,879.21	83.69%	13.35%
Hospital care	648.2	2,162.83	30.79%	4.91%
Professional services	660.2	2,202.87	31.36%	5.00%
Physician and clinical services	447.6	1,493.49	21.26%	3.39%
Other prof. services	58.9	196.53	2.80%	0.45%
Dental services	91.5	305.31	4.35%	0.69%
Other PHC	62.2	207.54	2.95%	0.47%
Home health care and nursing home care	177.6	592.59	8.44%	1.35%
Home health care	52.7	175.84	2.50%	0.40%
Nursing home care	124.9	416.75	5.93%	0.95%
Retail outlet sales of medical products	276.0	920.92	13.11%	2.09%
Prescripton drugs	216.7	723.06	10.29%	1.64%
Durable medical equipment	23.7	79.08	1.13%	0.18%
Other nondurable medical products	35.6	118.79	1.69%	0.27%
Program administration and net cost of private health insurance	145.4	485.15	6.91%	1.10%
Government public health activities	58.7	195.86	2.79%	0.44%
Investment	139.4	465.13	6.62%	1.06%
Research	41.8	139.47	1.99%	0.32%
Structures and equipment	97.6	325.66	4.64%	0.74%

2007).

The uptrend was influenced mainly by increased use and other non-price factors, as drug prices remained relatively stable. Growth in use accounted for roughly half of the growth in drug spending compared with 20 percent of growth in 2005. Some of this can be attributed to Medicare Part D, as seniors with drug coverage use more prescriptions and are more likely to fill a prescription than seniors without coverage. Other factors include new indications for existing drugs, strong growth in several therapeutic classes, and increased use of specialty drugs.

The generic drug trend continued in 2006 spurred on by incentives such as tiered copayment structures, copayment waivers and step therapy; the loss of patent protection for a number of brand name drugs (e.g. Zoloft, Zocor and Flonase) that became available in generic form in 2006; the lack of new blockbuster drugs; and the introduction of generic prescription drug discount programs by retail outlets such as Wal-Mart.

Prescription drug spending growth is expected to average 8.2 percent between 2006 and 2017 (Catlin et al. 2008).

Medicare Part D. The Medicare Prescription Drug, Improvement and Modernization Act of 2003 changed health care financing by creating the Medicare Part D drug benefit. This new program, which was implemented in 2006, allows elderly and disabled Medicare beneficiaries to have access to prescription drug coverage through stand-alone prescription drug plans, Medicare Advantage prescription drug plans or Medicare-subsidized employer plans. Those covered by third party insurance before Medicare Part D took effect were covered by Medicaid, private insurance, state assistance programs, Medicare managed care plans or other government programs while those who were not covered paid for prescriptions out-of-pocket.

Medicare Part D's impact on overall prescription spending was modest but it did significantly impact the source of funds used to pay for prescriptions. The public share of drug spending increased from 28 percent to 34 percent while the private share fell from 72 percent to 66 percent. Before Part D took effect the Medicare share of total retail prescription drug spending was 2 percent; Medicare's share increased to 18 percent in 2006 when the coverage took effect.

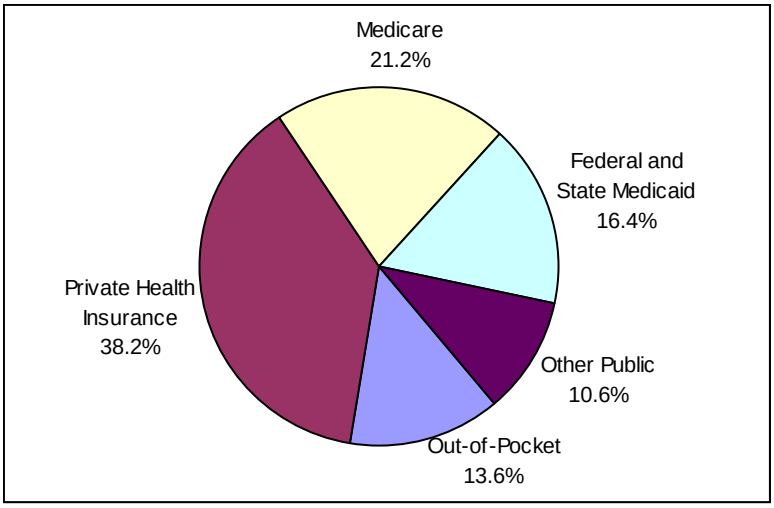
People who were dually eligible for Medicare and Medicaid (including those who previously had drug coverage through Medicaid) were automatically enrolled in the Part D program. This caused Medicaid drug spending to fall from 19 percent to 9 percent of total drug spending. Out-of-pocket spending was reduced from 24 percent of spending to 22 percent and private health insurance's share of drug spending fell from 48 percent to 44 percent. Medicare's overall share of federal spending increased from 29 percent to 34 percent while Medicaid decreased from 45 percent to 40 percent.

Health care sponsors

The shares of household and government spending have changed dramatically in the last 20 years. The household share of spending for health services and supplies fell from 40 percent in 1987 to 31 percent in 2005 and remained there in 2006. The share accounted for by governments increased from 30 percent to 40 percent in the same time frame. This is largely attributed to the expanded roles of Medicare and Medicaid. In contrast, busi-

nesses share of health spending has remained fairly constant at between 25 and 27 percent. State and local governments sponsored roughly the same proportion of health spending in 2006 as in 2005 although Medicaid accounted for a smaller fraction. The relative decrease in Medicaid was offset by increases in spending for other health programs.

Figure 4: Health Services Expenditure by Sponsor



State and local government spending growth slowed to 5.8 percent down from 9 percent in 2005, while household spending growth accelerated to 6.2 percent partly attributable to premium payments associated with Medicare Part D. Federal government health spending increased to 9.2 percent up from 7.1 percent in 2005. This was primarily driven by the increase in Medicare spending.

Medicare and Medicaid. Medicare spending increased by 18.7 percent in 2006, the largest increase since 1981 and 9.4 percent more than the 2005 increase. This is due in large part to the Medicare Part D prescription coverage and increased administrative costs due to the increase in enrollment. When these costs are factored out, Medicare spending increased only 6 percent in 2006 compared with 9 percent in 2005. Medicare fee-for-service (FFS) spending growth slowed as a result of a 0.2 percent fee schedule increase as opposed to 1.5 percent for 2005. FFS spending fell as a share of total Medicare spending from 86 percent in 2005 to 82 percent in 2006. Medicare Advantage spending increased 48 percent driven mainly by a 25 percent enrollment increase.

Medicaid spending decreased 0.9 percent in 2006. This was the first drop since the program was created in 1965. This is entirely the result of the automatic switch in prescription drug coverage from Medicaid to Medicare for dually eligible enrollees. When drug spending is removed Medicaid PHC spending grew 5.6 percent in 2006, still slower than the 8 percent increase in 2005.

Medicaid enrollment growth slowed to 0.2 percent in 2006 due primarily to improved economic conditions and more restrictive eligibility criteria. Increasing Medicaid cost pressures have been a serious concern for states in recent years but the pressure to reduce costs has decreased somewhat as the fiscal conditions of many states has improved.

Private health care spending. Private health insurance premiums grew at their slowest rate since 1997 at just 5.5 percent in 2006. A decline in private health insurance prescription drug spending and slower growth in underlying benefits contributed to the slowdown. Enrollment growth increased just 0.3 percent in 2006 and contributed only minimally to growth in premiums (Catlin et al., 2008).

Out-of-pocket spending growth slowed to 3.8 percent in 2006 as a result of the increase in the number of elderly with prescription drug coverage. Out-of-pocket spending's share of national health spending has been declining since 1998 and accounted for 12 percent in 2006. When prescription drug spending is removed, out-of-pocket spending grew 5.3 percent. Growth in out-of-pocket spending on health care was less than growth in nominal GDP and personal income; however, when overall household spending is calculated, the health care burden has remained fairly constant since 2003.

Washington Trends

CMS also tracks health spending trends at the state level. The publication of state level data lags national data by 1½ years, making 2004 the most recent year for which data is available (Martin et al. 2007).

Washington's per capita health expenditure grew an average of 5.6 percent per year between 1991 and 2004. This was slightly faster than the U.S. average of 5.5 percent per year. Healthcare spending growth in Washington seems to have accelerated in the latter half of this period, growing an average of 4.2 percent (0.6 percent below the national average) between 1991 and 1998 and then accelerating to 7.3 percent between 1998 and 2004, far outpacing the U.S. average of 6.3 percent.

Washington's 2004 per capita expenditure was $5,092 slightly below the U.S. average of $5,283. Among the states, Washington's per capita spending ranked 33rd . The states with the highest per capita health care spending in 2004 were Massachusetts, New York and Alaska, with per capita expenditures ranging from $6,540 to $6,450. The states with the lowest per capita expenditure were Utah, Arizona and Idaho with expenditure ranging from $3,972 to $4,444.

Washington's Medicare per enrollee expenditure for 2004 was $6,200, more than $1,200 dollars below the national average and ranking 38th among the states. Per enrollee Medicare spending grew 5.6 percent per year, on average, from 1991 to 2004 in Washington, compared to 6.1 percent for the nation as a whole.

Figure 5: Health Services Expenditure in 2004

		Washington State	
	U.S.	Amount	Rank
Health Care Spending Per Capita	$5,283	$5,092	33
Medicare Spending per Enrollee	$7,439	$6,200	38
Medicaid Spending per Enrollee	$6,119	$5,339	40
Share of Population in Medicaid	15.0%	14.9%	18

Medicaid per enrollee spending in Washington was $5,339, nearly $800 dollars below the national average and ranking 40th. Per enrollee spending grew by 2.7 percent per year, on average, from 1991 to 2004, compared to 4.3 percent for the nation as a whole. The relative slowness of Washington's per-enrollee spending growth was largely the result of the state initiatives to increase the number of children on Medicaid. (Children are relatively cheap to serve.) The initiative to enroll children contributed to the expansion in the number of Washingtonians served by Medicaid. In 2004, 14.9 percent of Washington's population was enrolled in Medicaid, up considerably from the 8.7 percent of Washington's population enrolled in 1991. In that year 9.9 percent of the U.S. population was enrolled in Medicaid.

Medicare and Medicaid made up 31.2 percent of Washington's health care spending in 2004, below the U.S. average of 37 percent.

Conclusion

Three years of slower health care spending growth have been a welcome change for families and governments who had to cope with rapidly inflating health care costs during the 1999 to 2003 period. The rapid growth in that period was in part the product of the transition away from tightly managed care. The recent tempering in the growth of health care's share of GDP also reflects a period of faster-than-average GDP growth. CMS estimates that national health expenditure grew 6.7 percent in 2007 and projects that growth will continue at this pace through 2017. This means health care spending will out pace expected GDP growth by 1.9 percent per year. This difference will mean the health care share of GDP will continue to climb, reaching 19.5 percent by 2017.

This steady growth is attributable to divergent spending trends in public and private payer spending. Private payer spending growth is expected to slow from 6.6 percent in 2009 to 5.9 percent in 2017. In contrast, public health care spending growth is expected to accelerate as more baby-boomers become eligible for Medicare.

Personal health care spending growth will be driven by medical prices and utilization, as well as smaller impacts from population growth and the age-sex mix. Medical price growth is expected to slow through 2012 and then accelerate through 2017. Utilization is influenced by disposable household income, which rose between 2002 and 2007. After 2008, however, household disposable income growth is expected to slow causing utilization to stall towards the end of the projection period.

Prescription drug spending growth is expected to accelerate through 2017 due to increased utilization. While Medicare drug spending is expected to grow faster than overall drug spending, Medicare Part D is expected to have little impact on overall health spending growth through 2017.

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