# What is the best prescription for our health care system?

## Part I: Do incumbents in the US health care industry actually earn outsized profits?

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# Introduction

In a series of papers, we will explore the potential drivers of the US health expenditure dilemma and identify potential mitigating solutions that are worthy of consideration in the years ahead. In this first of the series, we examine the role that industry profits play in driving national health expenditure (NHE).

Over the last two decades, the United States has spent an increasing amount per year of its gross domestic product (GDP) on health care.[1] The projected growth rate is faster than inflation, wage or productivity growth, and ultimately unsustainable. This fundamental challenge will likely come to a head in the near future — indeed, it already has, in the debate among policymakers, think tanks and the media. This debate often centers around objections to outsized private sector profits. While our analysis supports the idea of above-average returns for major health care incumbent corporations, it is our conclusion that, despite popular rhetoric, simply eliminating excess profits will not significantly reduce US health care spending.

# Health care costs: the data

Leading up to the COVID-19 pandemic, health care spending as a percentage of US GDP was already on a steady upward trajectory. While spending decreased in 2020 – as increased pandemic costs were more than offset by huge decreases in elective procedures and other non-urgent care – this is clearly an anomaly.

Per capita health care spend increased from $4,564, or 12.5% of GDP,[2] in 2000 to $11,072, or 17.8% of GDP, in 2019. In 2019, NHE comprised $3.8t of total US GDP of $21.4t[3] – three times more per capita than that of peer countries. Yet despite such high spending, the US lags behind its Organisation for Economic Co-operation and Development peers on such key indicators as life expectancy and mortality rates. Further, the Centers for Medicare & Medicaid Services (CMS) projects that NHE will grow 5.5% annually to $6t in 2028[4] (pre-COVID-19).

To understand this phenomenon systematically, we have followed a simple formula to evaluate costs, volumes and profits within the health care system. For the purposes of this paper, we use the following framework to define and analyze NHE:

**NHE** = Price × Volume

**Price** = Cost + Profits

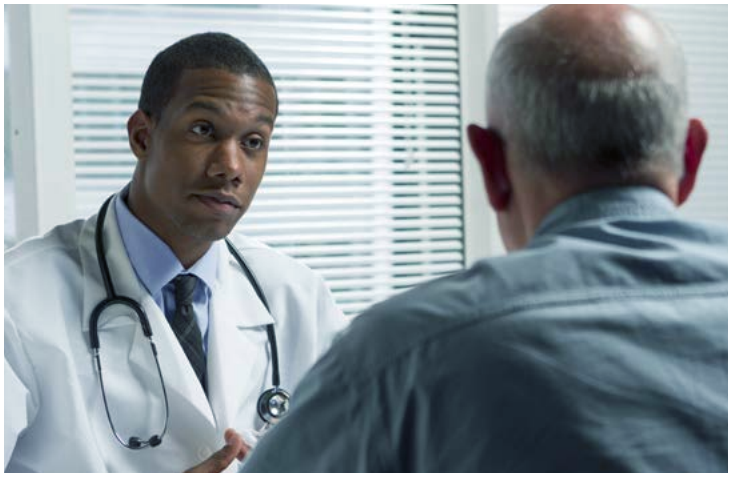
**Total profits** = Average profits earned across industries + Excess profits (if any) earned over average returns

**NHE** = [Cost per capita + Average profits earned across industries + Excess profits (if any) earned over average returns] × Volume

# Health care costs: the debate

Most critiques of the health care system eventually revert to the question of private sector returns. Article "Is Big Pharma To Blame For Soaring Health Costs?" noted that both the Republican and Democratic presidential candidates agreed on one thing: drug prices were too high, and hence, pharmaceutical manufacturers must be "reined in."[5,6]

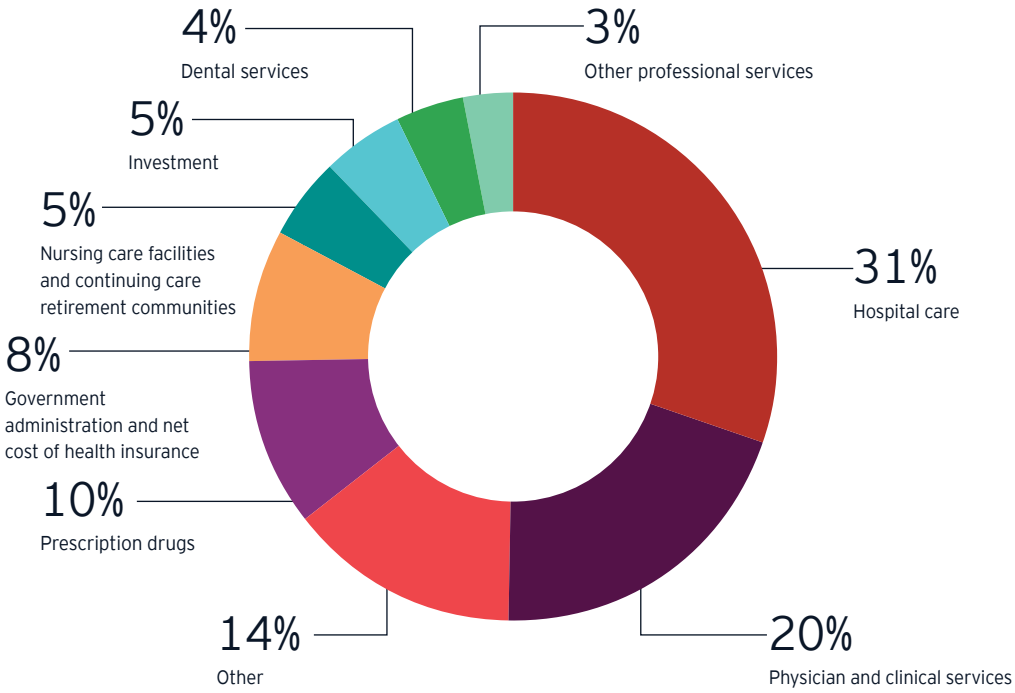
Article "Health Care and Profits, a Poor Mix," argues that the entire system of for-profit health care was to blame: "[P] rofit-maximizing tactics point to a troubling conflict of interest that goes beyond the private delivery of healthcare. Our track record suggests [this results in] social goods of lower quality, distributed more inequitably and at a higher cost than if government delivered or paid for them directly."



# Our analysis

To properly analyze the question of the role that private sector profits play in runaway US health care costs, we should first understand the structure of the industry and the relative economics of the sectors within the industry. The following pie chart (Figure 1) breaks down US NHE by health care subsector.

**Figure 1: 2019 US NHE by subsector***

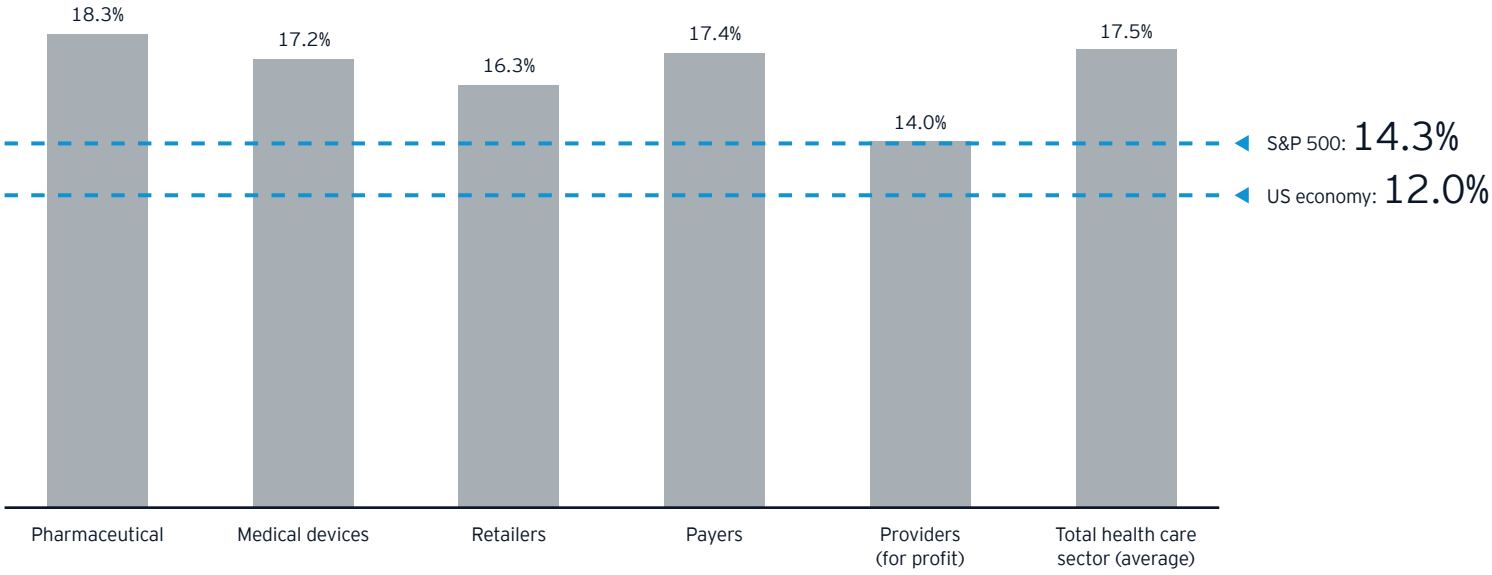



Note that more than half (~ 56%) of NHE is spent on some form of provider – 31% on hospital care, 20% on physician and clinical services, and 5% on nursing care facilities. A significant majority (~ 80%) of the hospital and provider sector is made up of not-for-profit entities.[7] Therefore, we estimate that approximately $1.7t of total NHE of $3.8t is spent by not-for-profit entities that operate at low or negative margins (breaking down the math: $1.7t = 56% × 80% × $3.8t of NHE; the not-for-profit health care sector margin was approximately 2% in 2018–19).[8]

* National Health Expenditure Projections 2018-2027, Centers for Medicare & Medicaid Services website, https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/ForecastSummary.pdf, accessed 8 November 2021.

These not-for-profit entities within the health care industry certainly do not generate excess profits. However, the for-profit entities across sectors, which contribute approximately $2t of NHE, do enjoy meaningful profits, as shown via the chart below (Figure 2).

**Figure 2: Return on capital employed (ROCE) of for-profit enterprises within health care industry sectors, 2001–2015; Compustat data**




Note: Providers can be defined as a combination of hospital care, physician and clinical services, dental services, home health, etc. The provider industry is very fragmented, with publicly available financial data on only a few companies, since a significant majority of these entities (80%) are not-for-profit and therefore not represented in the graph above.

To assess whether these for-profit enterprises across sectors truly earn excess profits — that is, outsized profits when compared with the US economy as a whole — we compare health care sector ROCE (= total returns/total capital employed; a common metric to gauge profit for an enterprise or sector) to the remainder of the economy. The analysis above shows that average returns from 2001 to 2015 for the health care industry were 3.2% higher than the S&P 500 and 5.5% higher than the US economy. The 5.5% difference between ROCE for the for-profit total health care sector vs. the US economy contributed some $75b–$112b in profits.

This analysis shows that the health care and life sciences industry, in aggregate, has slightly higher ROCE. This should not be a surprise and can be explained by the intrinsic R&D risk assumed by the industry and time-bound patent expirations of its products. To that end, an effort to align cost and outcome may be warranted as a way to gain a better understanding of how overall cost contributors could be mitigated. This would entail a variety of interventions, with many enabled by technology, encompassing all industry sectors.

We will continue our analysis of health care industry drivers in the next section of this series by taking on NHE itself, specifically volume and cost.

# Endnotes


[1] National Health Expenditure Accounts: Methodology Paper, 2019: Definitions, Sources, and Methods, https://www.cms.gov/files/document/definitions-sources-and-methods.pdf, Centers for Medicare & Medicaid Services, 2019.

[2] "U.S. Healthcare Spending 2000-2021," Macrotrends website, https://www.macrotrends.net/countries/USA/united-states/healthcare-spending, accessed 8 November 2021.

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[4] National Health Expenditure Projections 2018-2027, Centers for Medicare & Medicaid Services website, https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/ForecastSummary.pdf, accessed 8 November 2021.

[5] Deborah Quilter, "Is Big Pharma To Blame For Soaring Health Costs?," Forbes, https://www.forbes.com/sites/nextavenue/2016/10/18/is-big-pharma-to-blame-for-soaring-health-costs/?sh=57345bdd5b5d, 18 October 2016.

[6] Eduardo Porter, "Health Care and Profits, a Poor Mix," New York Times, https://www.nytimes.com/2013/01/09/business/health-care-and-pursuit-of-profit-make-a-poor-mix.html, 8 January 2013.

[7] Hospital Financial Analysis, True Cost of Health-Care website, https://truecostofhealthcare.org/hospital_financial_analysis/, accessed 8 November 2021.

[8] Alia Paavola, "Fitch: Nonprofit hospital margins improve for first time since 2016," Becker's Hospital CFO Report, https://www.beckershospitalreview.com/finance/fitch-nonprofit-hospital-margins-improve-for-first-time-since-2016.html, 4 September 2019.


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