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Medicare pricing drives high health-care costs

By [Peter Whoriskey](#) and [Dan Keating](#), Published: December 31, 2013

Medicare may be best known for paying the medical bills for millions of people 65 and older, but recent studies show it plays another gargantuan role in American health care: It helps determine prices for everyone.

For virtually every procedure and service — from routine colonoscopies to brain surgery and hospice care — Medicare comes up with a dollar figure that the government considers a fair price. But economists are finding that, largely because of the program's vast scale, Medicare prices substantially shape what all Americans pay for health care.

“Our results suggest that Medicare's decisions are far more influential than you may imagine,” said Joshua Gottlieb, an economist at the University of British Columbia. His research shows that a \$1 change in the price that Medicare pays yields a \$1.30 change in what private insurers pay.

What happens if the government gets those prices wrong? In the past year, a Washington Post investigation has shown that Medicare prices are sometimes [based on faulty premises](#), [offer perverse incentives for unnecessary care](#) and [provide widely varying amounts for equivalent drugs](#).

The government may be spending billions of dollars more than necessary for some products and services. Moreover, the influence of Medicare prices means that those faults may be replicated throughout U.S. health care.

Over the next year, agency officials said they will be developing new ways of determining the value of physician work and also altering other payment systems, such as those for hospice care.

“It's a very big problem — Medicare pays too much for a lot of stuff it buys,” said Bruce Vladeck, who headed Medicare under President Bill Clinton. “If you had better pricing policy, a whole lot of hysteria about long-term insolvency of Medicare would go away.”

“Medicare is a wonderful program, but behaviorally, because of the price-fixing, it's a mess,” said Tom Scully, who was Medicare chief during the George W. Bush administration and is now a partner in a private-equity firm that invests in health care.

Moreover, while some fault private interests for gaming the pricing system, Scully and others said that the root of the problem is mispricing by Medicare.

“It's all about economic incentives,” Scully said. “If you lay the bread crumbs out, you can't blame people for following.”

A stark report on prices

To many observers, including the bipartisan National Commission on Fiscal Responsibility and Reform, federal health-care spending represents the nation's single largest fiscal challenge in the long run.

At the heart of this is Medicare, which, even after the Affordable Care Act is fully implemented, will consume more federal money than any other health-care program, according to estimates from the Congressional Budget Office.

Medicare spending is forecast to rise by about 7 percent per year, partly because of the aging of the population and partly because per-patient costs will rise.

Ten years from now, net federal spending for Medicare will amount to \$903 billion, according to the CBO, while spending on Medicaid and children's health insurance will come to \$578 billion and spending for the health insurance exchanges and related items will come to \$134 billion.

Economists believe that the Medicare prices are even more important than that massive scale suggests, because in the absence of a traditional market for medical services, the Medicare prices form the foundation for private insurers, as well.

That is partly because Medicare is such a huge player in the market, accounting for more than a fifth of the money spent on personal health care. But there is a second, possibly more important impetus: Because of the complexity of modern medicine, setting prices is an arduous, time-consuming task. Insurers save money by letting Medicare do the work.

To measure the impact of Medicare prices, Gottlieb and Jeffrey Clemens at the University of California at San Diego analyzed millions of claims to see how changes in Medicare prices were followed by changes in the prices that private insurers paid. The results were stark.

"Our results indicate that the private sector will copy Medicare's pricing errors," Gottlieb said. "On the flip side, they would gain when Medicare payments better reflect the value of what is being delivered."

While that paper largely studied physician fees and outpatient services, other research published in May found that Medicare pricing for hospitals is similarly influential. The paper, by health care researcher Chapin White and published in *Health Affairs*, found that a 10 percent reduction in Medicare pricing yielded a 3 or 8 percent reduction in private prices, depending on the statistical method used.

Political pressure

Not surprisingly, given the importance of Medicare prices, Congress has struggled with the issue for years.

A new and untested approach known as the Independent Payment Advisory Board became law under the health-care law, creating a government panel to review Medicare costs. But one of the essential problems is that Medicare pricing so often becomes subject to political pressure.

"Go through every single payment system in Medicare and each one is highly political," Scully said. "I can tell you a war story about every one of them."

"When you are creating winners and losers, the losers will cry pretty loudly," said Stephen Zuckerman, a health economist at the Urban Institute.

In Congress, the pharmaceutical companies, doctors, hospital chains and medical device companies have donated more than \$72 million to the current membership of three key health subcommittees, with about \$42 million concentrated in support of a dozen of the most influential members, according to the Center for

Responsive Politics, a nonprofit and nonpartisan research group.

“People can’t not be affected by the money that comes in through campaign contributions,” said Rep. Jim McDermott (D-Wash.), who has long argued for reform of physician payments. “You know that at the end of the day, the donors are keeping score.”

McDermott, however, believes the problems will eventually be addressed.

“Democracy is an evolutionary process,” he said, “by which we figure out, ‘This ain’t working.’ ”

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