

# Administrative costs of health care coverage

Administrative costs are frequently cited in debates about health system reform. There is widespread agreement that excessive costs and unnecessary burdens are imposed by complex procedures for filing insurance claims; countless Medicare, Medicaid and state insurance regulations; and new cottage industries that assist third-party payers with billing, repricing payments to physicians and hospitals, managing pharmaceutical benefits, and other nonclinical activities. The American Medical Association (AMA) advocates reducing administrative and other nonclinical costs that do not contribute value to patient care as one of several broad strategies to address rising health care costs (see “Strategies to address rising health care costs” in this series). While proponents of alternative approaches to health care reform agree that administrative costs represent an opportunity for cost-savings, they differ over the magnitude of potential savings and proposed solutions. Shedding light on health care administrative costs can narrow disagreement over alternative approaches to health system reform and provide a common basis for making evidence-based public policy decisions.

## Different diagnoses, different prescriptions

The single-payer view holds that excessive administrative costs are inherent to any system of multiple, competing insurers, making private insurance less efficient than public programs such as Medicare, Medicaid and the State Children’s Health Insurance Program. High administrative overhead, insurer profits and multiple sets of procedures for filing insurance claims are seen as a central cause of the inefficiencies and inequities of the current system, and are believed to account for unfavorable cost and health comparisons between the United States and other countries. This analysis and point of view supports the position that private health insurance should be replaced by government-provided coverage, with administrative savings more than offsetting the additional costs of covering everyone.

The AMA has a contrasting view, one that sees excessive administrative costs as secondary to—and symptomatic of—fundamental flaws in the way health insurance is currently provided and paid for. According to this view, many people are unfairly shut out of the health insurance system because of ill-conceived government policies—specifically, health insurance tax subsidies that don’t help the poor, and health insurance regulations that don’t protect the sick. Flawed tax and regulatory policies are also blamed for driving up administrative costs by imposing 51 arbitrarily different sets of insurance rules from states and the District of Columbia, which, in turn, drive all but the largest insurers out of many markets, often

giving them excessive market power. This diagnosis points to a very different prescription for expanding coverage and curbing administrative costs: Redesign health insurance tax breaks, market rules and safeguards so that health insurance markets work properly, and so that coverage is affordable for everyone, regardless of income or health status. This approach, described more fully elsewhere in this series, is advocated by a broad range of individuals, policymakers and organizations.

## Frequently cited administrative cost estimates

Given the wide variation in administrative cost estimates, government data provide a natural reference point. The annual National Health Expenditures (NHE) accounts report administrative expenditures of \$143 billion in 2005. This amounts to 7.2 percent of total U.S. health care spending, broken out as 14.1 percent for private insurers and 5.2 percent for public programs (3.1 percent for Medicare and 7.0 percent for Medicaid). NHE data also show more rapid growth of administrative expenditures for public programs than for private insurance in recent years.

By comparison, industry estimates of administrative costs of private health plans generally are somewhat lower than NHE because they do not count insurer profits as part of administrative costs. Such inconsistencies in how administrative costs are defined make it difficult to determine the extent to which differences in estimates reflect differences in health plan efficiency.

Unlike industry or NHE estimates, other measures include a broader array of administrative costs not limited to those incurred by insurers, yielding estimates that are orders of magnitude higher. A study conducted by prominent single-payer advocates amassed data from the United States and Canada on the expenses of physicians, hospitals and employers for filing insurance claims, maintaining medical records, administering employee health benefits and so forth.<sup>1</sup> The study found that administrative expenditures in the United States were four times higher than reported by NHE in 1999, or 31 percent of total health care spending, compared with only 17 percent in the predominantly government-run Canadian system. Similarly, within the United States, administrative expenses associated with private insurance were found to be much higher than those of Medicare. The authors concluded that the bulk of these costs could be avoided if the United States were to adopt a Canadian-style health care system.

## A closer look at administrative costs

These frequently cited estimates have been criticized for incorrectly measuring and reporting administrative costs in various ways that, together, exaggerate differences between private and public insurance, and the United States and Canada.

Major shortcomings of administrative cost estimates include the following:

- **Ignoring unreported administrative costs of government programs.** Perhaps the most obvious shortcoming of many estimates is that they ignore unreported spending on administration of government programs. Such uncounted administrative costs are especially evident in the Medicare program and include:
  - Tax collection to fund Medicare—this is analogous to premium collection by private insurers, but whereas premium collection expenses of private insurers are rightly counted as administrative costs, tax collection expenses incurred by employers and the Internal Revenue Service do not appear in the official Medicare or NHE accounting systems, and so are usually overlooked
  - Medicare program marketing, outreach and education
  - Medicare program customer service
  - Medicare program auditing by the Office of the Inspector General
  - Medicare program contract negotiation
  - Building costs of the Centers for Medicare & Medicaid Services (CMS) dedicated to the Medicare program
  - Staff salaries for CMS personnel with Medicare program responsibilities
  - Congressional resources exhausted each year on setting Medicare payment rates for services
- **Reporting administrative costs as percentages rather than dollars.** Presenting administrative costs as a percentage of total health care costs gives a misleading impression of Medicare's efficiency relative to private insurance. Medicare patients are an expensive population, with much higher medical costs per person and per claim relative to the general privately insured population. Thus, an identical dollar amount of administrative cost per enrollee or per claim in the two sectors would make Medicare administrative costs appear lower. For example, a \$10 administrative cost per insurance claim represents 10 percent of a \$100 claim but only 1 percent of a \$1,000 claim. Similarly, rising medical costs of Medicare enrollees create the appearance that Medicare is becoming administratively more efficient over time.
- **Confusing costs of regulatory compliance with health plan inefficiency.** Private insurers face administrative costs not imposed on public programs, such as the need to comply

with multiple sets of state and federal regulations. Both overregulation and arbitrary differences in regulation create unnecessary administrative costs and prevent cost-savings from economies of scale. Private insurers also must pay premium taxes, usually counted as an administrative expense, driving up administrative costs as a percentage of total costs and creating the appearance of reduced efficiency.

- **Failing to recognize indirect costs not reflected on an accountant's ledger.** Tallying up dollars spent on all administrative activities for public and private insurance alike, along with addressing the other issues just discussed, would greatly improve administrative cost estimates and comparisons—but still would not capture indirect, hidden costs of insurance administration. These indirect costs depend on how basic administrative functions are accomplished, functions that are necessary for both private and public insurance, including collecting revenues, managing use of services, and paying physicians and hospitals. Adopting a single-payer system in the United States might eliminate health plans' administrative expenditures on curbing use of services, for example, by preauthorizing services, establishing tiered benefits, and monitoring the practice patterns of physicians and hospitals. However, these activities would inevitably be replaced by other methods of curbing overuse that carry their own costs, such as longer waiting times and restricted treatment options.

## Toward fairer comparisons

Several analyses have sought to make fair comparisons between private and public insurance by addressing common shortcomings of administrative cost estimates. A pair of studies of Medicare administrative costs that included unreported expenditures on the program made by numerous government agencies concluded that Medicare administrative expenditures were at least three times the amount reported in the federal budget in 2003—\$15.0 billion vs. \$5.2 billion.<sup>2,3</sup> Another administrative cost analysis—possibly the most comprehensive and methodologically rigorous to date—examined a wide array of costs borne by insurers, health care providers, and patients in the United States and Canada, paying particular attention to indirect costs of carrying out basic administrative functions.<sup>4</sup> The study calculated costs, net of associated benefits, of explicit and implicit methods of collecting revenues, curbing use of services and paying providers. For example, longer waiting times in Canada implicitly keep utilization of health care services in check, generating indirect costs to patients from delayed treatment and missed work. The study found that indirect, hidden administrative costs dwarfed monetary expenditures, concluding that true administrative costs are many times higher in Canada than in the United States.

## Administrative costs in perspective

The AMA believes that usual methods of estimating administrative costs ignore important facts, thereby overstating differences between private and public insurance, and that administrative costs are actually lower than generally reported in the private sector and higher than generally reported in the public sector. Furthermore, the AMA believes that even if administrative dollar expenditures were indisputably lower in a single-payer system, any administrative advantages would be offset by inefficiencies, longer wait times, restricted individual choice, lost productivity, reduced quality and decreased incentives for medical innovation. Likewise, the AMA regards administrative costs as being overshadowed by other, more fundamental flaws in the current health care system that, if corrected, would put coverage within everyone's reach regardless of income or health status, as well as rein in excessive administrative costs. In short, the AMA advocates a clear role for government in financing and regulating health insurance coverage, with health plans and health care services continuing to be provided through private markets, as they are currently. As described throughout this series, the AMA proposal reflects important social values and traditions—such as assistance based on need, freedom of choice, market innovation and fairness—by giving patients more control over our nation's health care dollars, without sacrificing personal security or choice.

## What to do?

That being said, there clearly is room to improve the administrative efficiency of the U.S. health care system. The AMA supports the following specific measures to simplify needlessly complex administrative procedures and regulations:

- Develop and adopt a consistent format for defining, estimating and reporting administrative costs, in order to facilitate unbiased comparisons across different types of insurance and health care systems.

- Achieve greater national uniformity of market regulation across health insurance markets, regardless of type of sub-market (e.g., large group, small group, individual), geographic location or type of health plan.
- Encourage the continued development of patient- and physician-friendly electronic systems to efficiently handle pricing, billing and claims processing at the point of service.
- Press the insurance industry to adopt more standardized claims-filing processes.
- Reduce nonclinical health system costs that do not meet cost-effectiveness criteria of adding value to patient care.
- Institute broader reforms to promote value-based decision-making so that decisions of insurers, patients, physicians and others take both costs and benefits into consideration. As described in “Strategies to address rising health care costs,” decision-making can be improved through increased market competition, greater availability and transparency of information, and incentives.

Visit [www.voicefortheuninsured.org](http://www.voicefortheuninsured.org) for more information on the AMA proposal and to view additional pieces in this series.

## References

1. Woolhandler S, Campbell T, Himmelstein DU. Costs of health care administration in the United States and Canada. *N Engl J Med.* 2003;349(8):768–775.
2. Litow ME. *Medicare versus Private Health Insurance: The Cost of Administration.* Milliman Inc. [www.cahi.org/cahi\\_contents/resources/pdf/CAHIMedicareTechnicalPaper.pdf](http://www.cahi.org/cahi_contents/resources/pdf/CAHIMedicareTechnicalPaper.pdf). Published January 6, 2006. Accessed November 20, 2007.
3. Matthews M. *Medicare's Hidden Administrative Costs: A Comparison of Medicare and the Private Sector.* Council for Affordable Health Insurance. [www.cahi.org/cahi\\_contents/resources/pdf/CAHI\\_Medicare\\_Admin\\_Final\\_Publication.pdf](http://www.cahi.org/cahi_contents/resources/pdf/CAHI_Medicare_Admin_Final_Publication.pdf). Published January 10, 2006. Accessed November 19, 2007.
4. Danzon PM. Hidden overhead costs: is Canada's system really less expensive? *Health Aff.* 1992;11(1):21–43.

